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Quality control manual for CPA firms

Robert D. Goldstein

Sherman L. Rosenfield

American Institute of Certified Public Accountants (AICPA)

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Quality Control Manual For CPA Firms

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S I N G L E V O L U M E

Quality Control Manual For CPA Firms

Authors:

Robert D. Goldstein, CPA

Sherman L. Rosenfield, CPA

A I C P A

I N T E G R A T E D

P R A C T I C E

S Y S T E M

AICPA

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Quality Control Manual For CPA Firms

Authors:

Robert D. Goldstein, CPA

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Editor:

Moshe S. Levitin, CPA

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P R A C T I C E

S Y S T E M

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This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

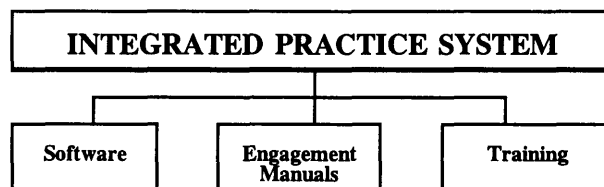
The documentation in this manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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1 2 3 4 5 6 7 8 9 0 T I 9 9 8 7 6 5

The AICPA Integrated Practice System: For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.
- **Include access to technical support hotlines** that put you in touch with professionals who can answer your technical questions. Just call the following numbers:

Engagement Manuals 800-TO-AICPA (800-862-4272)

Software Products 800-226-5800

Training 201-938-3061

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.
- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Bank Audit Manual

The three-volume *Bank Audit Manual* can help you cope with the high risk generally associated with bank audits and the complexity of bank operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a bank's internal control structure and assess risk during engagement planning;
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities;
- The AICPA Audit and Accounting Guide, *Audits of Banks*.

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms*, gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as three proposed exposure drafts of AICPA Statements of Position on consolidations, joint costs, and the applicability of authoritative pronouncements to not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches — the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- **Period Reporting** — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed *by* accountants *for* accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An Orientation and Technical Update Seminar is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement *you select* as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3061.

PREFACE

The AICPA *Quality Control Manual for CPA Firms* is designed as a complete tool for establishing and maintaining your quality control system. The Manual can be used by firms of all sizes, but it was written with the small- to medium-sized firm in mind—its practical and simple approach gives you everything you need to comply with the AICPA Quality Control Standards without overburdening you with unnecessary procedures and documentation.

This Manual is designed to help you in your practice. As long as your work is already technically competent, following the principles and procedures outlined in this Manual should put you well on the road to a successful review.

Some of the sample documentation contained in this Manual are:

- Client Acceptance and Continuance Form
- Planning Memorandum
- Altman Zeta (Z) Score Calculation Form
- Financial Statement Control Form
- Engagement Performance Review Checklist
- Peer Review Program Questionnaires
- Independence Query and Representation Form
- CPE Record and Evaluation Form
- Checklist for Coordinating an Inspection Program
- Consultation Form
- Candidate Evaluation and Reference Check Form
- Staff Evaluation Form
- Time Accumulation and Summary Forms

TRAINING

The AICPA has developed formal training sessions for practitioners on how to implement the Integrated Practice System Engagement Manuals in an accounting and auditing practice. Presently these sessions are conducted at various AICPA conferences throughout the year in cities nationwide. For more information on these training sessions, please call (201) 938-3061.

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS) AUDIT MANUAL ADVISORY TASK FORCE

Edward F. Rockman, *Chair*
Ernest F. Baugh, Jr.
John R. Benham, Jr.

Michael R. Council
Robin Hoag
William Metz

HOW TO USE THIS MANUAL

Quality Control Manual for CPA Firms is designed to help you pass your peer review with only a minimal amount of disruption to your practice. Without some help, many CPA firms would probably fail a peer review if they were forced to undergo one today—even though the basic quality control standards have been in effect for over 15 years. With some guidance and perseverance, however, most CPA firms can pass their reviews with a minimum of worries. A bit of effort and commitment on your part *now* should enable you to save yourself headaches and dollars later.

This Manual shows you how. It is written by two CPAs who have been through the process and know how it works, and it will provide you with the practical, comprehensive, step-by-step guidance and forms that you will need. It should be useful to all firms, but it was written with the small- to medium-sized practice—the forgotten silent majority of public accounting—in mind. If your practice is one of these, you will find that this Manual is geared to your needs.

Its easy-to-use, how-to-do-it approach is enhanced by highlighted practice tips, and ready and easy-to-use forms.

In addition, unlike most other quality control manuals, this Manual provides you with guidance from the AICPA's *Statements on Responsibilities in Tax Practice*. At this time, your peer review may not cover these statements, but tax is an important aspect of your overall practice and you cannot ignore these statements.

Organization of This Manual

This Manual is divided into 16 chapters.

The first two chapters introduce you to key quality control requirements and concepts. Chapter 1 provides you with an overview of quality control and review programs generally, including administering entities and enrollment information. Chapter 2 discusses overall design and implementation considerations. Several forms and exhibits, including a summary of key terminology and terms and a comparison of PCPS and SECPS membership requirements, are also provided to assist you in understanding the basics of designing, implementing, and monitoring your quality control program.

The nine key functional areas, or specific elements of quality control identified in *Statement on Quality Control Standards No. 1* (SQCS No. 1), are discussed in the next nine chapters:

Chapter 3—Independence

Chapter 4—Consultation

Chapter 5—Supervision

Chapter 6—Professional Development

Chapter 7—Acceptance and Continuance of Clients

Chapter 8—Hiring

Chapter 9—Assigning Personnel to Engagements

Chapter 10—Advancement

Chapter 11—Inspection

Each of these chapters sets forth the key operative standards, explains how you design your quality control system to comply, sets forth AICPA sample policies, and provides you with key forms for use in your firm.

Chapter 12 summarizes minimum documentation and other key compliance concepts that firms have found particularly problematical.

Chapters 13 and 14 tell you how to actually prepare for your review (on-site or off-site).

Chapter 15 explains state positive enforcement programs.

Chapter 16 tells you how you can institute a quality control system for your tax practice.

Updating and User Feedback

To keep users up-to-date with the changes in peer review requirements, we will be updating this Manual periodically. In that light, we welcome feedback from users of this Manual; please provide us with any recommendations, corrections, or copies of your firm's forms and checklists. Send your suggestions to: Susan L. Menelaides, CPA, Director, Technical Information Division, American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ, 07311-3881.

This edition of the Manual has been updated to reflect the authoritative pronouncements, including related interpretations, and AICPA reference manuals, through the following:

Statement on Quality Control Standards No. 1

Standards for Performing and Reporting on Peer Reviews (Effective April 3, 1995, as Amended)

Statements on Responsibilities in Tax Practice No. 8

Statements on Auditing Standards No. 74

Statements on Standards for Attestation Engagements No. 3

Statements on Standards for Accounting and Review Services No. 7

Peer Review Program Manual (January 1995)

SECPS Peer Review Program Manual (January 1995)

PCPS Reference Manual (November 1993)

SECPS Reference Manual (January 1995)

ABOUT THE AUTHORS

ROBERT D. GOLDSTEIN, CPA

Considered one of the Southwest's leading authorities on quality control, Robert D. Goldstein, CPA, is the past chairman of the Quality Review Committee of the Texas Society of Certified Public Accountants (TSCPA), which implemented the American Institute of Certified Public Accountants' (AICPA's) peer review program in that state, and a practitioner emphasizing accounting and auditing engagements and peer reviews. Mr. Goldstein's firm is a member of both the PCPS and the SECPS.

Mr. Goldstein is a partner of a large local CPA practice in Houston, Texas and also enjoyed a 14-year tenure with a national accounting firm. A past chairman of the Quality Control Committee of the Houston chapter of the TSCPA, Mr. Goldstein has served as the outside report review consultant to the TSCPA's Public Practice Association and has performed approximately 200 AICPA quality reviews and PCPS peer reviews. In addition, he has authored and taught a number of acclaimed CPE courses and is a frequent contributor to leading regional and national publications.

SHERMAN L. ROSENFELD, CPA

Sherman L. Rosenfield, CPA, served, for 14 years, as Quality Control Director at a leading local firm in Florida, and, prior thereto, enjoyed an eight-year tenure with a national CPA firm. He is currently a sole practitioner in Miami, Florida, providing quality control services to local CPA firms.

As a leading independent consultant to local firms, Mr. Rosenfield performs pre-issuance concurring reviews of financial statements and workpapers, develops systems of quality control (including customized forms, checklists, and manuals) and advises on the related complexities of practice administration.

A former Chairman of the Accounting Principles Committee, a member of the Ethics Committee, and the Quality Review Technical Resolution Committee of the Florida Institute of Certified Public Accountants, Mr. Rosenfield has captained or participated in numerous peer reviews and is uniquely qualified to bring a vital, hands-on perspective to every page of the *Quality Control Manual for CPA Firms*.

ABOUT THE TECHNICAL REVIEWER

ELMA SATTERFIELD, CPA

Elma Satterfield is a Senior Technical Manager in the AICPA Peer Review Division. The Peer Review Division provides staff support to the Peer Review committees and works with the Peer Review Board in the development and implementation of the Institute's peer review program. Since the inception of the AICPA's practice monitoring programs in 1978, over 38,000 reviews have been performed.

Before joining the Institute in 1981 as a manager in the former Quality Review Division, Mrs. Satterfield worked for the public accounting firm Mitchell/Titus & Company in New York City.

A native of Norfolk, Virginia, she graduated from Herbert H. Lehman College of the City University of New York with a Bachelor of Science in Accounting and was certified as a CPA in New York State in 1974.

PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

QUALITY CONTROL MANUAL FOR CPA FIRMS

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Quality Control Manual for CPA Firms*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report is included on the following page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.



January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

**Baird,
Kurtz &
Dobson**

Certified
Public
Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Quality Control Manual for CPA Firms* (materials) of the **AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)** in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned materials of the AICPA and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

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SUGGESTED REVISIONS TO QUALITY CONTROL MANUAL FOR CPA FIRMS

Please submit all suggestions to improve the quality of this Manual as they arise. We value users' input and will give all comments consideration when revising the Manual.

To:
Susan Menelaides, CPA
Director, Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

(Name)

(Firm)

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INTRODUCTION

A January 1988 vote of the American Institute of Certified Public Accountants (AICPA) membership brought about some sweeping changes in the accounting profession. In particular, all AICPA members in public practice must undergo a mandatory peer review of their accounting and audit practice—or face loss of AICPA membership. No other profession has been so openly willing to provide such a powerful internal mechanism for self-improvement. Approximately 48,000 CPA firms have enrolled in the AICPA's practice monitoring program.

The peer review program does not require you to do anything that is materially different from what professional standards already prescribe. Your review will simply be a means of monitoring and evaluating your compliance with the AICPA's existing standards of quality control, as described in *Statement on Quality Control Standards No. 1* (SQCS No. 1) and *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (SAS No. 25). It has been incumbent upon you, for many years, to follow those standards in your accounting and auditing practice, regardless of whether you ever planned to have your practice reviewed.

This Manual is designed to help you in your practice. As long as your work is technically competent, following the principles and procedures outlined in this Manual should put you well on the road to a successful review. Remember, your review should be a source of pride to you, not something to fear.

CHAPTER 1

**INTRODUCTION TO QUALITY CONTROL SYSTEMS AND
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CHAPTER 1

INTRODUCTION TO QUALITY CONTROL SYSTEMS AND PRACTICE-MONITORING PROGRAMS

1.000 OVERVIEW

1.001 If your CPA firm performs any audits, reviews, or compilations, its accounting and auditing practice must have a peer review every three years—a review that is approved by the American Institute of Certified Public Accountants (AICPA). Otherwise, you and your firm’s staff will lose your AICPA memberships. Your firm may also be subject to positive enforcement requirements in your state (see Chapter 15).

1.002 This chapter is designed to provide you with a basic conceptual framework for implementing your quality control system. Thus, it reviews four basic areas:

1. What a quality control system is, and what objective and subjective factors you should consider in tailoring your firm’s system (see section 1.400);
2. How practice monitoring works, and how you can evaluate the choices that the AICPA practice monitoring programs offer (see section 1.500);
3. Authoritative AICPA literature, and how you can use your familiarity with it to strengthen your quality control system and help you with your peer review (see section 1.600); *and*
4. What collateral benefits a quality control system offers your practice (see section 1.700).

1.003 Before you review the areas listed above, however, you might find it helpful to review the introductory sections at 1.200 and 1.300, which are designed to give you a quick-reference summary of the purpose and history of the accounting profession’s program of quality control.

1.004 Key terminology and concepts are explained throughout this discussion; they are also summarized in the exhibit in sections 1.902–1.925.

1.100 RULES FOR CPA FIRMS WITH NO ACCOUNTING AND AUDITING PRACTICE

1.101 If your firm has no accounting and auditing practice whatsoever (that is, it issues *no* financial statements of any kind), it is exempt from the peer review requirements. In such a case, contact your firm’s administering entity to apply for an exemption. (Administering entities are discussed in sections 1.520–1.522. How to apply for an exemption is further discussed in section 14.004 of Chapter 14.)

Practice Tip:

The definition of an accounting and auditing practice is very broad, and your firm probably has some sort of accounting and auditing practice (see sections 1.530–1.532).

Are You Wondering Whether You Should Terminate Your Firm's Accounting Practice?

1.102 If you are like many proprietors, partners, and shareholders of local firms, you may be saying to yourself: "I have only a few accounting engagements. I really can't justify keeping them if I have to spend a lot of money to have a peer review. I don't really want to terminate my AICPA membership. What should I do?"

1.103 The authors recommend that your firm remain enrolled in one of the AICPA's peer review programs—so that you and your employees can retain your AICPA memberships. By staying enrolled in a peer review program, you will avoid having to re-enroll in the program later and having to reinstate your AICPA membership and the memberships of your partners and employees. The costs, incidentally, are very reasonable. (See Chapters 13 and 14 for more information on estimated costs and what you can do to help control them.)

Practice Tip:

Complying with the quality control standards is not really that difficult for most local firms. This Manual will walk you through the process.

1.200 PURPOSE OF A QUALITY CONTROL SYSTEM

1.201 Quality control is a term that arose in industry. It refers to a systematic means of testing or inspecting a product to ensure that certain predefined specifications or tolerances are being satisfied. Industry achieves an objective measurement by setting precise standards and monitoring compliance with them.

1.202 The profession, or art, of accounting, however, involves professional judgment, and precise "cookbook" results are not possible. In accounting and auditing, the purposes of quality control are:

1. Efficient delivery of professional services,
2. Compliance with Statement on Auditing Standards No. 25 (SAS No. 25), *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*,
3. Compliance with Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*,
4. Enhancement of public confidence in the profession, and

5. Risk reduction.

(Some of the collateral benefits you can expect are discussed in section 1.700.)

Efficient Delivery of Practical Professional Services

1.203 Your firm's real work product is service, an intangible that is subjective and sometimes difficult to evaluate. Your firm's quality control system is one of your principal tools for ensuring that you provide practical professional services to your accounting and auditing clients.

Practice Tip:

Although its objective is to ensure that your firm complies with professional standards, the AICPA's practice monitoring program is also designed to be educational as well as remedial. The term "practice monitoring" is not clearly defined in accounting literature. However, page 23 of the AICPA's 1987 *Plan to Restructure Professional Standards* refers to the purpose of practice review as "assuring quality performance and reducing or eliminating substandard performance."

Compliance With SAS No. 25

1.204 SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*, specifically emphasizes and confirms that you must adopt a quality control system to obtain reasonable assurance that your staff is following generally accepted auditing standards (GAAS). (See also sections 1.602–1.603.)

Compliance With SQCS No. 1

1.205 Some practitioners took the position that, because SAS No. 25 is an *auditing* standard, its quality control standards did not apply to accounting practices that did not involve audits. To correct this conceptual misunderstanding, SQCS No. 1 established that nine generally recognized quality control standards apply to your unaudited financial statement practice as well as to your auditing practice, if any.

Enhancement of Public Confidence in the Profession

1.206 The accounting profession, on the whole, does good work. Considering the hundreds of thousands (possibly millions) of financial statements issued in the United States each year, the audit failures that are widely publicized are unfortunate exceptions. A Louis Harris poll that is frequently quoted in AICPA literature showed that accounting was widely regarded as one of the most competent, honest, and objective of all professions. However, the profession is also in such a high position of public trust and so closely scrutinized that it must do everything in its power to maintain and enhance the public confidence.

1.207 The Securities and Exchange Commission (SEC) and the General Accounting Office (GAO) have both studied the relationship of practice monitoring to performance. The results persuasively indicate that CPA firms that have had peer reviews (and, therefore, have established quality control systems) are far

less likely to do substandard work than those that have not been reviewed. Reporting on a study of 48 SEC enforcement actions against accountants from 1981 through 1986, an SEC release noted that "the incidence of enforcement actions against accountants which had not undergone peer review was approximately eleven times higher than for accountants which had...." The GAO found problems in 59% of audits by accountants who had not been peer reviewed but in only 18% of audits by those who had been reviewed (as reported in the AICPA's *PCPS Reporter* newsletter, July 1987). Some state boards of accountancy and state CPA societies have made similar findings; some states have found 30% to 40% of all audits to be substandard (see "For the Members, By the Members," *Journal of Accountancy*, Vol. 164, No. 4, October 1987, page 118).

1.208 As a result of such findings, and of the media coverage that has surrounded certain audit failures (principally concerning publicly held companies and financial institutions), Congress, state legislatures, and state boards of accountancy have increasingly turned their attention to the public accounting profession and the possibility of additional regulation (see discussion in section 1.300). The profession has decided that it must, therefore, improve its already high level of performance—or somebody else will probably try to do it for us.

1.300 BACKGROUND OF QUALITY CONTROL

1.301 Quality control considerations are not new. The accounting profession has always had a deep interest in providing the highest quality of professional services possible. This interest has been intensified in the past 15 years or so, however, because of the political and economic climate in the United States. American society is highly litigious, and the media has spotlighted audit failures and numerous civil and criminal proceedings involving accountants. In the 1970s, the late Senator Lee Metcalf (D.-Mont.) turned his attention to investigation of the accounting profession, and, more recently, Congressman John D. Dingell (D.-Mich.) and others have done the same.

CPA Firm Initiatives

1.302 Individual firms, particularly the large national firms, initiated their own quality control systems many years ago, based upon their own concepts of what an appropriate system should entail. Some formed review departments to challenge and approve financial statements, and sometimes the underlying workpapers, for financial statement engagements. Others required some form of "cold" or second person review of certain types of engagements. In some cases, interoffice standards review teams were formed to evaluate compliance with professional and firm standards.

State CPA Society and Accountancy Board Initiatives

1.303 In some states, CPA societies established quality control committees that function, or did function, in various ways. To give some examples:

- In the 1970s and 1980s, the Florida Institute of CPAs had a committee that reviewed financial statements and commented on whether they met professional standards. The reviewer's comments were transmitted confidentially to the practitioners, and no conclusions or comments were provided to third parties.

- In the mid-1980s, Texas practitioners could submit three representative financial statements to a report review service of the Texas Society of CPAs' Public Practice Association and receive confidential, risk-free comments on their work.
- New York established a voluntary Quality Review Task Force in 1973.

1.304 Some state accountancy boards also initiated review programs. Positive enforcement programs are likely to become the norm in other states in the future. (See sections 1.557–1.560, and Chapter 15.)

CPA Firm Association Initiatives

1.305 Associations of CPA firms have demonstrated a genuine interest in the quality standards of their member firms. Most require initial quality inspections of prospective members, and many require periodic peer reviews of all member firms.

AICPA Initiatives

1.306 The AICPA has taken several initiatives in the quality control area, in addition to its key authoritative announcements.

1.307 AICPA's "Future Issues Report." In its 1984 "Future Issues Report," the AICPA cited the need for additional emphasis on quality controls to increase the confidence of those who use the services of CPAs. One of the options cited was "making peer review mandatory for all firms." Another was "promoting positive enforcement and peer review programs at the state level to check the competency of practitioners" (*Major Issues for the CPA Profession and the AICPA*, AICPA Future Issues Committee, page 20).

1.308 AICPA's "Anderson Committee." In 1983, the AICPA appointed George Anderson to chair a Special Committee on Standards of Professional Conduct of Certified Public Accountants. The committee studied the relevance and effectiveness of professional standards in today's social and business environment.

1.309 One of the major concerns of the Anderson Committee was the need to monitor the quality of accounting and auditing work. The Committee's work resulted in the AICPA's *Plan to Restructure Professional Standards*, which in turn resulted in the formation of the AICPA's mandatory practice monitoring requirements.

1.310 Contrary to popular belief, the "Anderson Committee" was not a reaction to ongoing Congressional investigation. It was actually appointed three years *before* the Congressional committees began their investigations of the accounting profession, and the impetus was the accounting profession's desire to improve itself.

1.400 DESCRIPTION OF QUALITY CONTROL SYSTEMS

1.401 Your firm's quality control system is the overall set of policies and procedures that you must establish to provide your firm with reasonable assurance of conforming to professional standards.

1.402 An effective quality control system must meet the requirements of SQCS No. 1, which requires a firm to address each of the nine elements of quality control to the extent applicable to its practice. *But no single quality control system will work for all firms. You should custom-design your firm's quality control system to fit its specific needs.* If you are a sole proprietor or a partner in a very small practice, you do not need (and are not expected to have) a complicated quality control system like one that a national firm might need. Similarly, if your practice is a large one with many partners, and perhaps even several offices, it will probably need a system that is more elaborate than that of a small firm.

1.403 These issues are discussed in more detail in Chapter 2 where this Manual begins to address the issue of how *you* design and implement *your* firm's system. A conceptual overview appears below.

General Standards

1.404 SQCS No. 1 provides general standards you should *always* follow when you are tailoring a quality control system to your firm's unique needs.

System of Quality Control

1.405 Even if your firm is so small that a formal quality control system is not required, it still needs to have some system, albeit an informal one. SQCS No. 1 requires your firm's quality control system to be:

1. Appropriately comprehensive *and*
2. Suitably designed for the nature of your firm's accounting practice.

1.406 Your firm's quality control system should provide reasonable assurance that your firm will conform to professional standards. In particular, SQCS No. 1:

- Prescribes establishment of policies and procedures for each of the nine elements of quality control insofar as they are applicable to a firm's practice (see section 1.407);
- Requires communication of these policies and procedures to firm personnel (although the language of SQCS No. 1 does not differentiate between professional and other personnel, many CPA firms interpret it to mean *all* personnel); *and*
- Requires the firm to monitor the effectiveness of these policies and procedures.

The Nine Elements of Quality Control

1.407 SQCS No. 1 identifies nine specific elements of quality control. They are listed below in the order in which this Manual discusses them:

1. Independence (see Chapter 3),
2. Consultation (see Chapter 4),
3. Supervision (see Chapter 5),
4. Professional development (see Chapter 6),

5. Acceptance and continuance of clients (see Chapter 7),
6. Hiring (see Chapter 8),
7. Assigning personnel to engagements (see Chapter 9),
8. Advancement (see Chapter 10), *and*
9. Inspection (see Chapter 11).

Communication as Part of Quality Control

1.408 Your firm should communicate relevant policies and procedures to all personnel. You can have the greatest system in the world, but it will not work if nobody knows about it.

Documentation of Quality Control

1.409 Be sure to document your firm's quality control system—that is, its existence and your compliance with it. In order to avoid confusion, the following terms, although somewhat arbitrary, are used in this Manual: (1) Quality control document, (2) quality control materials, and (3) documentation (that is, written substantiation) of compliance with quality control standards and your own system.

1.410 Quality Control Document. Although not required, many firms document their quality control system with a written summary of the system. Depending on your needs, this document may be as brief as a short questionnaire or as lengthy as a voluminous manual. It communicates your major policies and procedures to your personnel. It is also the starting point for your peer review evaluation of your quality control system.

1.411 Quality Control Materials. Your firm's quality control materials include the manuals and the prototype (blank) forms, checklists, workpapers, practice aids, and so forth that you use in designing, communicating, implementing, complying with, and monitoring the firm's quality control system.

1.412 Quality Control Compliance Documentation. Your firm's quality control documentation consists of your actual completed forms, checklists, workpapers, etc., that you and your staff fill out and that provide evidence of compliance with your quality control system.

Monitoring of System Effectiveness

1.413 You must continually evaluate and, if necessary, revise your firm's quality control system so that you always know that your firm is in compliance with professional standards.

Objective Factors Affecting Quality Control System Design

1.414 How you design your firm's quality control system depends upon a number of relevant factors, such as:

- Firm size;

- Nature of practice;
- Organizational structure; *and*
- Number, location, and autonomy of offices.

(The impact of these factors is discussed in more detail in Chapter 2, sections 2.111–2.114.)

The Subjective Factor: Professional Judgment

1.415 Because of the variety of factors that can significantly affect the nature and scope of your firm's quality control system, and because of the subjectivity involved in accounting, no single quality control system is appropriate—or even useful—for all CPA firms. Professional judgment and common sense are needed in designing the right quality control system for your particular firm, and the evaluation of your system during your peer review requires the professional judgment of qualified and experienced reviewers.

1.500 PRACTICE-MONITORING PROGRAMS — 1995 MERGER OF THE AICPA QUALITY REVIEW AND PCPS PEER REVIEW PROGRAMS

1.501 Effective April 3, 1995, the PCPS Peer Review Program and the AICPA Quality Review Program combined to form one program—the AICPA Peer Review Program. All chapters of this latest edition of the *Quality Control Manual for CPA Firms* have been revised to reflect the new combined program. The following sections summarize some of the key features of the pre-April 3, 1995 AICPA practice-monitoring programs, followed by a summary of the changes and major features of the new Peer Review Program.

1.502 As you are probably aware, if you are an AICPA member and an employee or owner of a firm that engages in the practice of public accounting, your firm must be enrolled in an AICPA-approved practice-monitoring program as a condition of your membership in the AICPA.

Pre-April 3, 1995

1.503 Before April 3, 1995, the SECPS, the PCPS, and the AICPA Quality Review Program administered fully independent practice-monitoring programs for firms enrolled in their programs. While these three programs were very similar, there were some important differences, as described below:

- (1) The reviews performed under the SECPS and PCPS were called "peer reviews" and the reviews performed under the AICPA Quality Review Program were called "quality reviews."
- (2) SECPS and PCPS peer reviews included additional procedures for testing compliance with SECPS and PCPS membership requirements, such as the requirement that all professional staff meet the AICPA's CPE requirements, and the appropriate reporting on the procedures performed. SECPS peer reviews also include special procedures related to SEC clients.

- (3) For firms with 10 or fewer professionals, quality reviews focused on four of the nine quality control elements: Independence, Consultation, Supervision, and Professional Development. PCPS peer reviews focused on these four elements plus Inspection; and SECPS peer reviews focused on the same four elements plus Inspection and Acceptance and Continuance of Clients.
- (4) Quality reviews were "administered" (that is, reviews were scheduled and the results evaluated) by the state CPA societies or the AICPA Quality Review Division (now known as the AICPA Peer Review Division). SECPS and PCPS peer reviews were administered by the AICPA Quality Review Division.
- (5) Firms that performed compilations and/or reviews, but no audits, were eligible for off-site reviews under the AICPA Quality Review Program and PCPS Peer Review Program. No off-site reviews were (or are) allowed under that SECPS Peer Review Program.

Post-April 3, 1995

1.504 On April 3, 1995, the PCPS Peer Review Program and the AICPA Peer Review Program (formerly the AICPA Quality Review Program) combined and the PCPS revised its membership requirements to require a PCPS member firm to comply with the requirement for mandatory peer review by having a review administered under the AICPA Peer Review Program or, if it is or becomes a member of the SECPS, a review administered by that section, and with the following additional peer review requirements:

- (1) Each member of a review team performing a peer review of a PCPS member firm must be associated with a PCPS member firm. Also, the firm with which the team captain is associated should have received an unqualified report on its most recent peer review and that report should have covered the firm's compliance with the PCPS membership requirements.
- (2) The report, the letter of comments, and the reviewed firm's response would be placed in the public files of the section at AICPA headquarters. If additional actions are deemed necessary by the committee responsible for administering its review, a memorandum indicating that they have been accepted with the understanding that the firm will agree to take certain actions would also be placed in the public file. The letter setting forth those actions and the firm's agreement to undertake them would be placed in the public file upon receipt.
- (3) The peer review would include appropriate tests of the firm's compliance with the membership requirements of the section, and the report will include an opinion on whether the reviewed firm complied with the membership requirements of the section in all material respects and, if not, a description of the reasons for the qualification.

1.505 The primary reason for the combination was to eliminate confusion among many AICPA members and the public as to the distinction between the terms "peer review" and "quality review." A secondary benefit is an economic one: there is now one oversight and administrative body instead of two for firms that do not audit public clients. The SECPS Peer Review Program is unchanged.

1.506 Most firms previously enrolled in the PCPS or the AICPA Quality Review Program (and not the SECPS) will see little change from the combination because it mainly affects administrative and

oversight matters. The combination does not change the actual review procedures. Below is a recap of those changes and key features of the new Peer Review Program.

- (1) *Oversight Responsibility.* The AICPA Quality Review Executive Committee has been renamed the "AICPA Peer Review Board." The Board has been given responsibility for establishing and conducting the AICPA Peer Review Program in cooperation with state CPA societies and for overseeing reviews of PCPS firms and firms enrolled in the AICPA Peer Review Program. (In October 1995, the PCPS Peer Review Committee will be disbanded.)
- (2) *Standards for Performing and Reporting on Peer Reviews (the Standards).* Effective April 3, 1995, The *Standards for Performing and Reporting on Quality Reviews* were revised and renamed the *Standards for Performing and Reporting on Peer Reviews*. The PCPS peer review standards and the quality review standards were very similar, except for one important difference: PCPS peer reviewers were required to perform the additional procedures for testing compliance with PCPS membership requirements.

The new *Standards* provide one set of uniform standards, with the additional procedures that apply only to PCPS firms regarding compliance with PCPS membership requirements and the special peer review requirements established by the Private Companies Practice Executive Committee. The new standards implement a minor change in the standard reporting language to conform to the new AICPA Peer Review Program terminology. For PCPS firms, a fourth paragraph has been added to the standard report regarding the firm's membership in and compliance with the PCPS membership requirements.
- (3) *Administrative Responsibility.* Before April 3, 1995, most quality reviews were administered by the state CPA societies and all PCPS peer reviews were administered by the AICPA Quality Review Division. (Some quality reviews were administered by the AICPA's Quality Review Division.) After April 3, 1995, all peer reviews under the AICPA Peer Review Program will be administered by state CPA societies, including reviews of PCPS firms.
- (4) *Confidentiality.* For non-PCPS firms, peer review results will continue to be confidential, while peer review results of PCPS firms will continue to be kept in a public file at the AICPA.

What Does this Mean for Your Firm?

1.507 If your firm was previously enrolled in the AICPA Quality Review Program, it is now automatically "enrolled" in the new PRP. In fact, because most state societies were already administering quality reviews, most firms will see virtually no change in the way their reviews are administered and accepted — about the only change they will notice is the terminology change from "quality review" to "peer review." If your quality review was previously administered by the AICPA (because your state elected not to administer its reviews), your review will now be administered by your state CPA society or another state society.

1.508 Before April 3, 1995, peer reviews of all PCPS firms were administered by the AICPA. Now, these peer reviews will be administered by a state CPA society. If your firm is a PCPS member, this means that you will now correspond with your state society, rather than the AICPA, on such matters as the scheduling of your review and the acceptance of your peer review report, letter of comments, and letter of response. Because most state societies now have several years' experience in administering

quality reviews, the authors believe that the state societies and PCPS firms will easily adapt to this change. If your firm has not participated in an AICPA-approved practice-monitoring program, you will need to either enroll in the PRP (see section 13.200 of Chapter 13) or join the AICPA's Private Companies Practice Section or SEC Practice Section.

AICPA-Approved Programs

1.509 AICPA members must be associated with one of the AICPA-approved practice monitoring programs. That requirement can be satisfied by being a member of the:

1. AICPA Peer Review Program (PRP), *or*
2. Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms. Reviews of PCPS firms are administered under the AICPA Peer Review Program, *or*
3. SEC Practice Section (SECPS) of the AICPA Division for CPA Firms.

1.510 The most recent authoritative literature on peer reviews (except SECPS peer reviews) is the AICPA's *Standards for Performing and Reporting on Peer Reviews*, effective April 3, 1995, which covers the AICPA Peer Review Program.

Practice Tip:

This publication is directed toward those who are going to administer or conduct peer reviews, but you will find it helpful in preparing for your own review. Take the time to read it.

1.511 The PCPS and the SECPS both distribute looseleaf reference manuals to their members at no additional cost. These manuals include useful information about those sections of the AICPA. The SECPS manual also includes copies of all of the checklists and questionnaires that an SECPS peer reviewer is likely to use. The AICPA Peer Review Program makes a similar manual, the *Peer Review Program Manual*, available for \$135 as a one-year subscription. You can also order a paperback version for \$55. This manual applies to all PRP and PCPS firms.

1.512 The *Peer Review Program Manual* can be ordered from the AICPA, P.O. Box 2209, Jersey City, NJ 07303. You can call toll-free at 1-800-862-4272.

Practice Tip:

While not required, you should obtain and become familiar with the appropriate manual for the peer review program in which your firm is enrolled.

1.513 Firms with SEC clients are *required to join the SECPS* (see section 1.517). Peer reviews under the AICPA Peer Review Program and the SECPS Peer Review Program may be conducted in various

ways, as discussed below (see also Chapters 13 and 14). Following is a summary of the different types of reviews under the two practice-monitoring programs:

<u>Program</u>	<u>Firms With Audits</u>	<u>Firms With Compilations and/or Reviews but NO Audits</u>	<u>Firms With NO Audits, Reviews, or Compilations</u>
Peer Review Program (PCPS and PRP Firms)	On-site Peer Review	Off-site Peer Review	Exempt
SECPS Peer Review Program	On-site SECPS Peer Review	On-site SECPS Peer Review	Exempt

Exempt PCPS and SECPS member firms must still submit documentation supporting their compliance with the membership requirements of those sections.

AICPA Peer Review Program

1.514 A firm that is not a member of the Division for CPA Firms must enroll in the AICPA Peer Review Program. Peer reviews under this program are administered by state CPA societies (in the few states that have elected not to administer the program, it will be administered by another state society, as discussed in sections 1.521–1.522). Reviews of PCPS member firms are also conducted under this program. The AICPA Peer Review Program has been tailored to the needs of the smaller CPA firm and, if your firm has 10 or fewer professionals, your firm's peer review under this program will be slightly less comprehensive than the SECPS peer reviews that are required for members of that section of the AICPA Division for CPA Firms.

Division for CPA Firms

1.515 In lieu of enrolling in the AICPA Peer Review Program, your firm may join the AICPA's Division for CPA Firms—either the PCPS or the SECPS. If your firm joins the PCPS it will have the same peer review as described in the preceding paragraph, but compliance with PCPS membership requirements will also be tested as part of that peer review. An SECPS peer review, however, is conducted pursuant to SECPS standards and, as mentioned above, is administered by the AICPA Peer Review Division (formerly the Quality Review Division) in New Jersey.

1.516 The AICPA's membership has traditionally consisted of individual CPAs. To promote the quality controls of firms, the AICPA formed the Division for CPA Firms in 1977. This division, in turn, consists of two sections, PCPS and SECPS. Approximately 6,900 firms, representing more than 134,000 professionals, belong to the PCPS. Almost 1,000 of those firms also belong to the SECPS. In addition, over 250 firms belong to the SECPS only. A firm that belongs to both sections will only be required to have an SECPS review.

Practice Tip:

A peer review of a PCPS or SECPS member firm goes beyond an evaluation of the profession's required quality control standards because it also evaluates a firm's compliance with the membership requirements of the PCPS or the SECPS. Although peer reviews have historically been viewed as a significant part of the work of the Division for CPA Firms, and peer reviews are indeed requirements for membership, the division's focus actually goes beyond practice monitoring. It also provides a means for member firms to make known their views on professional matters, including the establishment of technical standards. If you are seeking these added features, the authors believe your firm should join the Division for CPA Firms. Otherwise, you need only be enrolled in the AICPA Peer Review Program.

Mandatory Enrollment in SECPS

1.517 AICPA Council has defined an SEC client as:

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933, *or*
2. A registrant that files periodic reports (for example, Forms N-SAR and 10-K) with the SEC under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except a broker or dealer registered only because of Section 15(a) of the 1934 Act).

If your firm does not have any SEC clients, it is certainly welcome to join the SECPS, but it really does not need to do so.

Practice Tip:

The above definition does not specifically address Form 11-K filings required of certain pension plans under the Securities Exchange Act of 1934. Firms that audit such entities should consult with the staff of the SEC Practice Section of the Division for CPA Firms at 212-596-6134 in planning for their peer reviews, regardless of whether the review is being performed under the SECPS Peer Review Program or the AICPA Peer Review Program.

Off-Site Peer Review

1.518 An off-site peer review is a review that your firm can elect if it issues compilation or review reports but performs no audits. In an off-site peer review, the reviewer only reads the financial statements of selected clients and the accountant's compilation or review report, together with certain information the reviewed firm provides. Working papers are not reviewed.

1.519 Off-site peer reviews replace what were formerly known as off-site quality reviews and PCPS report reviews. Such reviews are *not* available to SECPS member firms. (See Chapter 14 for a detailed discussion of off-site peer reviews.)

Administration of AICPA-Approved Peer Review Programs

1.520 SECPS peer reviews are under the direct administration of the SECPS Peer Review Committee and the staff of the AICPA Peer Review Division (see further discussion in Chapter 13).

1.521 The AICPA's Peer Review Board (formerly the Quality Review Executive Committee) oversees the state societies' administration of PCPS and PRP peer reviews. The AICPA Peer Review Program is locally administered in most states. As previously mentioned, in the few states that have elected not to administer the program, reviews will be administered by another state society. However, most state CPA societies have elected full involvement in the program (see the exhibit in section 1.928), which basically means that, subject to certain AICPA guidance and assistance, peer reviews of CPA practices are administered, evaluated, and approved locally. Contact your own state CPA society for more information. (Section 1.928 provides a listing of state CPA societies.)

1.522 Although state boards of accountancy will probably recognize certain practice monitoring programs other than those of the AICPA, the fact remains that participation in one of the AICPA-approved programs will remain mandatory for AICPA membership.

Methods of Conducting AICPA-Approved Peer Reviews

1.523 The type of review team you can select does not depend on the type of review your firm will have. The types of review teams, as further discussed below, are:

- Committee-appointed review team (CART),
- Firm-on-firm review team, *or*
- Association review team.

It is your own choice whether to have a CART review, a firm-on-firm review, or an association-appointed team review.

1.524 In any case, the "team" for a review of a local firm will normally consist of only one person (the team captain). The basic impact is discussed below, and your choices—and the cost effect—are explained in more detail in Chapters 13 and 14.

Committee-Appointed Review Team (CART)

1.525 In a CART peer review, if your firm is a member of the PCPS or enrolled in the PRP, the review team is appointed by the state CPA society administering your review. SECPS CART review teams are appointed by the AICPA Peer Review Division staff under the direction of the SECPS Peer Review Committee.

Firm-on-Firm Review

1.526 For a firm-on-firm review, your firm hires another CPA firm to conduct the review, subject to the approval of your administering entity.

Association Review Team

1.527 An association of CPA firms may be authorized to sponsor and conduct peer reviews of its members in a manner similar to firm-on-firm reviews. If your firm is a member of a CPA association that qualifies as an authorized sponsor, you may elect to have a review team appointed by your association conduct your peer review under the supervision of your administering entity.

1.528 If your firm belongs to such an association of firms, your association should be able to tell you whether it has been qualified to sponsor AICPA-approved reviews.

Some Factors to Consider in Selection of an AICPA-Approved Practice-Monitoring Program

1.529 Which program is best for your firm? There is no "right" answer and, quite frankly, there is not that much real difference between the AICPA programs, although the PCPS and SECPS may be perceived as more prestigious. Some of the differences that do exist are set forth below. (See also the exhibit in section 1.927.)

Practice Tip:

Similar checklists and procedures are used in all peer reviews. If you are unsure about which program to join, be sure to protect your AICPA membership by enrolling your firm in the AICPA Peer Review Program. You can always change your mind and join PCPS or SECPS later.

Definition of an Accounting and Auditing Practice

1.530 The phrase "accounting and auditing practice" can have slightly different (but basically similar) meanings, depending on the context in which it is used. In a generic sense, an accounting and auditing practice is one that has *any* type of financial statement engagement. SQCS No. 1 uses the phrase "accounting and auditing and review services for which professional standards have been established."

Definition Under Peer Review Standards

1.531 For AICPA Peer Review Program purposes, an accounting and auditing practice is one that issues historical or prospective financial statements for clients, other than the planning-type presentations of personal financial information described in *Statements on Standards for Accounting and Review Services No. 6* (SSARS No. 6). The AICPA's *Standards for Performing and Reporting on Peer Reviews* defines an accounting and auditing practice [.30] as:

[A]ll auditing, review, and compilation services covered by Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, the Statement on Standards for Attestation Engagements *Financial Forecasts and Projections* and standards for financial and compliance audits contained in *Government Auditing Standards* issued by the U.S. General Accounting Office (the Yellow Book).

Definition in SECPS Standards

1.532 For SECPS peer review purposes, the SECPS's definition of an accounting and auditing practice is essentially the same as that quoted above. The official definition in the *SEC Practice Section Reference Manual* (Section 2000.04, footnote 2) is:

[A]ll auditing, and all accounting, review and compilation services covered by generally accepted auditing standards, standards for accounting and review services, financial forecasts and projections and proforma financial information sections of the standards for attestation engagements, and *Government Auditing Standards* issued by the U.S. General Accounting Office (the Yellow Book).

Practice Tip:

The literature makes it clear that a peer review does not cover tax services or management consulting services, except to the extent that these services are associated with financial statements or relate to compliance with SECPS membership requirements. Accounting work related to tax provisions and tax accruals contained in financial statements *is* included in your firm's peer review.

Focus on Quality Control Elements

1.533 If your firm is a PCPS member or is enrolled in the PRP and has 10 or fewer professionals, its peer review will *ordinarily* focus on only four of the nine elements of quality control:

1. Independence,
2. Consultation,
3. Supervision, *and*
4. Professional development.

If your firm has 10 or fewer professionals and joins the SECPS, its SECPS review will *ordinarily* focus on *six* of the nine quality control elements:

1. Independence,
2. Consultation,
3. Supervision,

4. Professional development,
5. Acceptance and continuance of clients, *and*
6. Inspection.

Practice Tip:

It is important to understand that even a small firm having a peer review must *comply* with each of the nine elements of quality control to the extent they apply to its practice. In fact, your firm's peer reviewer can decide to include one or more of the additional elements as part of the review — if there appears to be a reason to do so. These elements are not a mandatory part of a small firm's peer review because, in most cases, the close supervision over operations that the proprietor or the partners provide means that compliance with these elements is inherent in the ordinary activities of the firm.

Definition of Professional Personnel

1.534 The definition of a professional is important, not only in determining whether all quality control elements will be examined in a peer review, but also in determining to whom certain quality control elements, such as professional development, hiring, and advancement, apply.

1.535 For peer review purposes, all employees who are CPAs, or who are expected to attain that designation during their careers, are considered professionals.

Practice Tip:

One gray area is the treatment of a full-charge paraprofessional who is fully capable of working on an engagement but who is not attempting to become a CPA. When in doubt, play it safe. As a practical matter, particularly in regard to continuing professional education (CPE) and professional development, the authors recommend that you treat anyone who works on a financial statement engagement as a professional.

Confidentiality

1.536 Peer review results of firms enrolled in the PRP (that are not PCPS member firms) are confidential. The results of reviews of PCPS and SECPS firms are maintained at the AICPA's offices and are available to the public.

1.537 A report is always issued for a peer review, even if it is adverse.



Termination of Reviews

1.538 An SECPS peer review may be terminated in rare instances, but only with the prior approval of the SECPS peer review committee. However, termination of a peer review generally will not be approved if the review team has noted significant engagement-related deficiencies. The *Standards for Performing and Reporting on Peer Reviews* do not provide for the termination of a review.

Requirements

1.539 The basic prerequisites for a peer review under the AICPA Peer Review Program are: (1) your firm must be enrolled in the AICPA Peer Review Program or be a member of PCPS, (2) for PRP firms, at least one owner of your firm must be an AICPA member, and (3) for PRP and PCPS firms, your firm should have a system of quality control for its accounting and auditing practice.

1.540 To participate in an SECPS peer review, your firm must join the SECPS and meet a number of membership requirements. An SECPS peer review evaluates compliance with the membership requirements of the SECPS in addition to compliance with all applicable elements of quality control.

1.541 A small firm's quality control system will probably be deemed adequate, even if the system itself is extremely informal, as long as no significant or pervasive deficiencies are found in the engagements reviewed. The emphasis will probably be on the real objective of a quality control system—compliance with professional standards.

1.542 The AICPA Peer Review Program is principally an educational and remedial practice monitoring program. In contrast, the PCPS is designed not only to improve the profession but also to provide a forum that member firms can use to make known their needs and views on professional matters, including the establishment of technical standards by the AICPA and the Financial Accounting Standards Board (FASB). Thus, the PCPS provides an advocacy function, addressing issues such as whether certain generally accepted accounting principles (GAAP) should apply to all entities or just to large ones (or, more colloquially, "big-GAAP" versus "little-GAAP"). The SECPS takes the PCPS function a step further and includes serving the public interest and public oversight.

Timing of Review and Enrollment in AICPA-Approved Programs

1.543 Your firm will, to a large extent, schedule its actual review (see Chapters 13 and 14) according to a set timeframe, which depends upon the program in which you enroll. Most CPA firms have already enrolled in a program. In fact, approximately 48,000 CPA firms have joined either the AICPA's Division for CPA Firms or the AICPA Peer Review Program. But, if you have misplaced your enrollment form or forgotten to mail it, the AICPA is still accepting enrollments.

1.544 The review timeframe, and enrollment information, are set forth below.

Practice Tip:

When you send in your firm's enrollment form, you will not be locked into a specific peer review program. If, for example, you enrolled in the AICPA Peer Review Program, you can later change your mind and become a member of the AICPA Division for CPA Firms. And conversely, you may change your firm's enrollment from the Division for CPA Firms to the PRP unless, of course, your firm is required to be a member of SECPS or PCPS (if your firm performs SEC or REA audits).

1.545 Once enrolled in an AICPA practice-monitoring program, your firm will have a review that is tailored to its size and to the nature of its practice. Firms with audit clients will have on-site reviews. PCPS and PRP firms without audit clients, but with compilation and review clients, will—unless they elect an on-site review—submit reports and financial statements (but not workpapers) for off-site reviews (see Chapters 13 and 14). SECPS does not allow off-site reviews.

1.546 Your firm's administering entity will notify you of the due date for your firm's peer review.

1.547 Newly formed firms must have their initial peer review within 18 months of enrolling in a peer review program.

1.548 Firms without accounting or auditing clients will not be reviewed. If such a firm later obtains an accounting or auditing client, however, it will be expected to have a review within 18 months of the fiscal year end of the first accounting or auditing client the firm accepts.

1.549 You can obtain an enrollment form from most state CPA societies or from the AICPA's Peer Review Division.

1.550 PCPS and SECPS Considerations. If your firm is a PCPS member and has a consulting review (see sections 2.328 and 2.329) within six months of joining the PCPS, your first peer review will generally not be due for 24 months from the date the firm joins the PCPS. If your firm joins the SECPS (for example, because it has accepted an SEC client), your first SECPS peer review must be completed within one year from the date your firm joins the SECPS, with certain exceptions. The authors recommend that you consult with the SECPS immediately if you have any questions in this area.

1.551 If your firm joins the SECPS, it *must* have an SECPS peer review every three years and must abide by somewhat stricter rules. For example, an explicit objective of the SECPS, which the PCPS does not embrace, is to "enhance the effectiveness of the section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members." Most SECPS members are also members of the PCPS, although dual membership is not required.

Practice Tip:

If your firm had a quality review prior to April 3, 1995 or a PRP peer review after that date, it can join the PCPS, and its next review will be due three years after the previous quality or PRP peer review. To qualify, you must submit your firm's quality review or PRP report and letter of comments, and your letter of response, for inclusion in the PCPS public files. Your firm also must meet other PCPS membership conditions and have satisfactorily completed any voluntary corrective action that your firm may have agreed to as a result of the prior review.

If your firm had a non-SECPS review, it can join the SECPS at any time and similarly defer its first SECPS peer review by submitting its existing review report, letter of comments, and letter of response to be included in a public file. In addition, your firm must have satisfactorily completed any voluntary corrective action that you may have previously agreed to as a result of your firm's prior review.

1.552 The following AICPA personnel are available to answer your questions about the Division for CPA Firms and to help you enroll:

- *PCPS membership requirements:* David Handrich, (212) 596-6145.
- *SECPS membership requirements:* Bruce Brasell, (212) 596-6134.

1.553 PCPS member firms pay annual dues of \$25 per *CPA*, up to a maximum of \$500 per year. SECPS member firms pay annual dues of \$19 per *professional staff person* with a minimum of \$250 per year. SECPS member firms with fewer than five SEC clients are limited to maximum annual dues of \$750.

1.554 Extensions. The peer review programs have a mechanism for reviewing requests to extend review due dates and for granting extensions on a case-by-case basis if they are warranted.

1.555 For an extension for most peer reviews, contact the entity that administers the program in your state (your state CPA society in most, but not all, states). For an extension for an SECPS peer review, contact the AICPA Peer Review Division in New Jersey.

Practice Tip:

If you think you need an extension, you must first understand that one will be granted only in rare and unusual circumstances. Not being ready for your review will not be an acceptable reason.

1.556 If you do have a valid reason, you should make your request in writing at least 60 days before your due date. Be sure to cite your specific reasons for your request, as well as a reasonably brief proposed extension period (usually in the same calendar year and not more than six months past your original due date).

AICPA-Approved Review Versus Positive Enforcement Programs

1.557 The discussion above has centered on AICPA-approved practice-monitoring programs. In addition, many states have positive enforcement programs that are separate from the AICPA-approved programs and often quite different in their nature and scope.

1.558 Positive enforcement programs are generally mandatory programs that state boards of accountancy have initiated in order to monitor the work products of practice units. These programs often are backed by remedial and punitive statutory enforcement provisions. Unlike the AICPA programs, they apply to all licensees within a particular state, regardless of whether they are AICPA members.

1.559 Although some state boards of public accountancy have mandated practice-monitoring programs for a number of years, others have never monitored the practices of their licensees. But most states will probably enact some sort of positive enforcement program in the reasonably foreseeable future. The trend is for state boards to initiate such programs.

Practice Tip:

Because your state board of accountancy will probably accept your peer review as a means of fulfilling its practice-monitoring requirement, your AICPA membership takes on added value and significance.

1.560 Positive enforcement programs, and the efforts of the National Association of State Boards of Accountancy to coordinate positive enforcement requirements with AICPA requirements, are more fully discussed in Chapter 15.

1.600 AUTHORITATIVE QUALITY CONTROL LITERATURE

1.601 For quality control purposes, the authoritative literature includes SAS No. 25 (which superseded SAS No. 4) and SQCS No. 1. Interpretations of SQCS No. 1 have been issued. So have policies and procedures both on establishing firm quality control policies and on performing and reporting on peer reviews, along with manuals for peer reviews.

SAS No. 25

1.602 SAS No. 25 requires accounting firms that perform audits to adopt a system of controls that reasonably ensure that the firm's professional staff is following GAAS. It was issued in November 1979, superseding SAS No. 4.

1.603 Released by the AICPA in December 1974, SAS No. 4 defined the nine quality control elements (see 1.407). For the first time, quality control standards were defined for the accounting profession as a whole and were no longer left to each firm's private determination of the nature and extent of its own quality control standards.

SQCS No. 1

1.604 SQCS No. 1 was released in November 1979, along with SAS No. 25. It is *the* authoritative source on quality control standards and continues to form the basis for all peer reviews and peer reviews. In issuing SQCS No. 1, the AICPA effectively moved the nine quality control elements out of the exclusive realm of GAAS and into the mainstream of professional standards that apply to nonaudit as well. SQCS No. 1 and its interpretations appear in Quality Control (QC) section 10 of *AICPA Professional Standards*. Its specific requirements are presented in more detail on a topic-by-topic basis in each relevant chapter of this Manual. You must comply with the standards of SQCS No. 1 if you want to pass your review.

1.605 SQCS No. 1 applies to all accounting firms that report on clients' financial statements, even if the statements are *not* audited. It uses the phrase "accounting and auditing and review services for which professional standards have been established." Thus, SQCS No. 1 may directly affect you, even if your firm does not perform any audits and your practice does not come under SAS No. 25.

1.606 SQCS No. 1 *permits* quality control standards to be applied to other areas, such as tax services or management advisory services, but it specifically makes application optional, except to the extent that the services are provided as a part of accounting and auditing services.

1.607 The scope of SQCS No. 1, and the various interpretations of it, are discussed extensively throughout this Manual. As we go to press, a proposal is underway to amend SQCS No. 1 but it must undergo "due process," including the circulation of an exposure draft. The amendments would clarify certain concepts and possibly slightly streamline the standards.

Quality Control Policies and Procedures for CPA Firms—Establishing Quality Control Policies and Procedures

1.608 In 1981, the AICPA released additional guidance on how to establish quality control policies and procedures pertaining to the nine elements of quality control. This document, *Quality Control Policies and Procedures for CPA Firms—Establishing Quality Control Policies and Procedures*, is now incorporated in QC section 90 of *AICPA Professional Standards* and includes illustrative policies and procedures that are reproduced as relevant in Chapters 3–11 of this Manual.

1.700 BENEFITS OF A QUALITY CONTROL SYSTEM

1.701 Besides the obvious benefit of keeping you in compliance with the quality control standards that were adopted in 1979, a good quality control system usually offers a firm the following collateral benefits:

1. Policy documentation,
2. Persuasive marketing tool,
3. Reasonable assurance about your work product,

4. Advance warning of potential problems,
5. Effective training tool,
6. Possible insurance premium savings,
7. Collections enhancement,
8. Increased proficiency,
9. A way to motivate personnel and improve morale,
10. Greater objectivity,
11. An opportunity to review other firms after passing your own review,
12. A tool for conforming to state board of accountancy requirements, *and*
13. A way to comply with revised *Government Auditing Standards*.

1.702 Once your firm's quality control system is operating properly, the factors discussed above should combine to give your firm a competitive edge over firms that do not maintain adequate control systems. A quality firm does quality work.

Policy Documentation

1.703 When you formalize your firm's quality control policies and procedures, you will automatically begin to document them in questionnaires, manuals, forms, checklists, and improved work paper documentation. This process not only permits you to communicate effectively to everyone on your staff but also facilitates and encourages a healthy exchange of ideas.

1.704 Documentation is particularly important if your firm is experiencing rapid growth or expects to grow in the future. What worked yesterday may not work tomorrow.

Persuasive Marketing Tool

1.705 Participation in a practice monitoring program can only enhance your image and credibility in the financial community.

1.706 Now that most CPA firms have had at least one review, firms that are not AICPA members and that have not participated in a practice monitoring program will probably find themselves at a disadvantage in the marketplace.

Reasonable Assurance About Your Firm's Work Product

1.707 If you are like most competent, professional practitioners, your firm's work is reasonably good from a technical standpoint, and therefore you should have little to worry about with respect to "passing" a peer review. In fact, you should look forward to your peer review as a confirmation that your work meets professional standards. If, on the other hand, your work has any shortcomings, you should welcome this opportunity to find out about, and correct, them.

Practice Tip:

Your firm's philosophy should stress that it will not tolerate second-rate work at any level. Your clients will have good reason to have confidence in you and your entire staff.

Advance Warning of Potential Problems

1.708 If your firm's reviewers note any major problems, you should be pleased to have them brought to your attention before it is too late to correct them. You should view your firm's review as an important litigation-avoidance tool. It may seem unpleasant to be criticized by your peers, but their criticism is certainly preferable to, and less costly than, embarrassment in court and/or the media.

Effective Training Tool

1.709 Reading and using your quality control materials will give your staff valuable on-the-job training. Staff members who participate in your annual inspection program will find the experience rewarding and educational. In addition, many firms find that their quality control programs force them to more effectively monitor their CPE programs for all members of their professional staff. This monitoring results in a more organized and sometimes more cost-effective professional development program. A common peer review finding is that CPE has fallen behind a firm's needs, particularly as a firm grows or develops new specialties.

Possible Insurance Premium Savings

1.710 An article in the September 1987 issue of the *Journal of Accountancy* reported that more lawsuits had been filed against accountants in the previous 15 years than in the entire previous history of the profession ("Accountants' Liability: Coping with the Stampede to the Courtroom," Vol. 164, No. 3, page 119). At present, most underwriters ask whether a firm has been peer reviewed in the previous three years and, if so, the nature of the opinion received. It is too soon to gauge the effects of practice monitoring programs on liability insurance rates, but it is reasonable to assume that those firms able to demonstrate their commitment to quality control will eventually enjoy lower rates than those firms that cannot.

Collections Enhancement

1.711 Two of the elements of quality control are (1) independence and (2) client acceptance and continuance. When you set an enforceable client acceptance and continuance policy (see Chapter 7), you will reduce the risk of performing services for which you cannot collect your fees, and you will ensure that your staff adequately considers client risk factors.

1.712 In addition, when fees are overdue for an extended period of time, the fees take on some of the characteristics of a loan and impair independence (see Chapter 3). Therefore, by highlighting independence considerations, you will reduce the chances that your staff will unwittingly perform additional uncollectible work for clients that have failed to pay for your services in prior years.

Increased Proficiency

1.713 Without question, each engagement you perform enhances—or detracts from—your professional reputation. Following an appropriate quality control system will enable you to enhance the proficiency of your firm and, thus, your overall reputation.

1.714 Even such a seemingly mundane quality control element as "assigning personnel to engagements" (see Chapter 9) can enhance the proficiency of your practice. For example, better scheduling may enable you to assign more work to lower-level staff than you have in the past, resulting in better on-the-job training for your staff, a lower effective hourly rate, and, thus, in either lower fees and/or higher profits.

Personnel Motivation and Morale

1.715 The accounting profession depends on people. An accounting firm relies heavily on the education, experience, and abilities of its staff, and a motivated staff is much more likely to be efficient and profitable than one lacking in motivation. When you implement a meaningful quality control system, you should see the following effects on your personnel:

- greater productivity,
- development of a team concept,
- more effective recruitment,
- more meaningful CPE efforts,
- greater job satisfaction,
- increased engagement proficiency,
- greater objectivity, and
- enhancement of collections.

Greater Productivity

1.716 Quality drives productivity. Your firm's quality control system should ultimately make it more productive and efficient and, thus, more profitable and satisfying.

Team Concept

1.717 In many CPA firms, the staff does not work together in harmony, principally because no one has either clearly explained what is expected of each member or supervised actual performance adequately. When you implement and communicate your quality control system, you will go a long way toward eliminating this type of inadvertent discord.

1.718 A team concept should arise from your quality control system—that is, the idea that members of your staff will consistently work together within established procedures to meet common goals. Everyone should have the same written policies and procedures to follow.

Recruitment

1.719 Participation in a recognized practice monitoring program is a definite advantage in selling your firm to prospective employees. You can probably anticipate that, as the peer review program becomes widely publicized, participation in this program will become the minimum credential that top candidates will demand of their prospective employers.

Meaningful CPE

1.720 Following the professional development portion of your quality control system will enable you to identify the specific CPE activities that will provide the most benefit to you personally and to your staff. Not only will compliance strengthen your firm's competence and capabilities, but it will also reduce your risk of wasting time and money on unneeded topics. (See section 1.709.)

Job Satisfaction

1.721 There is a noticeable correlation between staff morale and the quality of the work your staff does. Written policies and procedures remove the frustrations your personnel experience when they feel that no one has adequately told them what to do, how to do it, or how well they have performed. The team concept, and the obvious pride of belonging to a quality-oriented firm, tremendously boost the morale, motivation, and performance of your staff.

Greater Objectivity

1.722 Sometimes, while looking for new business or completing an existing engagement, the best of accountants can make hurried decisions without sufficient thought about the consequences. Compliance with your quality control system, however, will sometimes force you and your staff to slow down long enough to consider certain decisions more carefully. In some cases, you might be more objective than you otherwise would have been. Your firm's client acceptance and retention procedures, for example, may prevent it from taking on or retaining a client whose acceptance or retention it might later regret. Its supervision policies and procedures may enable you to catch a dangerous error that you might not have otherwise detected. Its hiring policies may force you to scrutinize more closely the qualifications of marginal or inappropriate job candidates.

Opportunity to Conduct Peer Reviews of Other Firms

1.723 Once you know how to set up and evaluate a workable quality control system and have passed your own review, you will become a good candidate to provide services to other CPA firms. Reviewing other firms or helping them with their quality control systems will generate additional revenue. You will also find that working with other firms is a worthwhile educational experience.

Conformity to State Board of Accountancy Requirements

1.724 If your state does not already impose some level of mandatory positive enforcement, as previously mentioned, it probably will soon do so. Your firm will need an effective quality control system in order to meet the applicable positive enforcement requirements (see Chapter 15).

Compliance With *Government Auditing Standards*

1.725 If your firm audits governmental agencies, the *Government Auditing Standards* ("Yellow Book") requires you to have an "external review." AICPA peer review programs qualify as such external reviews.

Practice Tip:

The Rural Electrification Agency (REA) has not designated the AICPA Peer Review Program as an approved program under its requirements. Therefore, if your firm conducts REA audits, it must be a member of PCPS or SECPS. Although reviews of PCPS firms are conducted under AICPA Peer Review Program Standards, unlike reviews of PRP firms, results of reviews of PCPS firms are included in the AICPA's public files.

1.800 SUMMARY AND CONCLUSIONS

Quality Control Monitoring Is Here to Stay

1.801 As media and legislative scrutiny of the accounting profession continues, it is becoming increasingly clear that the profession has two choices: It can either increase the actual and perceived quality of its work or expect increased intervention from outsiders. A profession-wide emphasis on quality control systems should go a long way toward mitigating the possibility of external interference.

1.802 SAS No. 25 and SQCS No. 1 require that you meet certain standards and comply with the nine elements of quality control. However, the nature of the quality control system your firm adopts will depend upon the unique factors of your practice. In addition, you can use the quality control process as an educational technique that will help you develop your practice in a way that gives it a competitive edge.

1.900 EXHIBITS

1.901 The following background information is provided to assist you in your understanding of the AICPA's quality control and practice monitoring requirements and to help you make basic decisions regarding your practice:

- A glossary of key terminology and concepts (see the exhibit in sections 1.902–1.925);
- A comparison of the different peer review programs available (see the exhibit in section 1.926);
- A comparison of PCPS and SECPS membership requirements (see the exhibit in section 1.927);
- A list of CPA societies (see the exhibit in section 1.928).

Also included for your assistance is a list of consultants available at the AICPA (see the exhibit in section 1.929).

Key Terminology and Concepts

1.902 You will understand quality control much more quickly and easily if you take a few moments to become familiar with the following basic terms and concepts. Rather than presenting terms alphabetically, as in a typical glossary, this discussion is organized so that each concept stems from the preceding one. Thus, they appear in the following order:

1. Quality control:
 - Quality control system,
 - Quality control document,
 - Quality control materials, *and*
 - Quality control compliance documentation.
2. AICPA quality control reviews/practice monitoring programs:
 - Quality review,
 - Peer review,
 - Off-site peer review,
 - Committee-appointed review team (CART),
 - Firm-on-firm review,
 - Association review team, *and*
 - Administering entity.
3. Positive enforcement programs.
4. Accounting and auditing practice:
 - SQCS No. 1 definition, *and*
 - Peer review definition.
5. Professional personnel.

1.903 Quality Control. Quality control is a term that arose in industry. It refers to a systematic means of testing or inspecting a product to ensure that certain predefined specifications or tolerances are being satisfied. Industry achieves an objective measurement by setting precise standards and monitoring compliance with them. The profession, or art, of accounting, however, involves professional judgment, and precise cookbook results are not possible.

◆ **1.904 Quality Control System.** Although you are not required to have a formal, written quality control document, most firms (even sole practitioners) find some form of documentation helpful. Each firm should have a unique quality control system that best meets its particular needs.

1.905 Quality Control Document. Although not required, your quality control document is your formal, written summary of your quality control system. Depending on your needs, this document may be as brief as a short questionnaire or as lengthy as a voluminous manual. It communicates your major policies and procedures to your personnel. It is also the starting point for the evaluation of your firm's quality control system which will take place during your firm's peer review.

1.906 Quality Control Materials. Your firm's quality control materials include the manuals and the prototype (blank) forms, checklists, workpapers, practice aids, and so forth that you use in designing, communicating, implementing, complying with, and monitoring your quality control system.

1.907 Quality Control Compliance Documentation. Your firm's quality control compliance documentation consists of your actual completed forms, checklists, workpapers, etc., that you and your staff fill out and that provide evidence of compliance with your quality control system.

1.908 AICPA Quality Control Reviews/Practice Monitoring Programs. All AICPA members in public practice must be affiliated with a firm that participates in an approved practice monitoring program. The approved practice monitoring programs for AICPA membership purposes are:

- AICPA Peer Review Program,
- Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms (PCPS peer reviews are administered under the AICPA Peer Review Program), *and*
- SEC Practice Section (SECPS) of the AICPA Division for CPA Firms.

These reviews are conducted in various ways, which are also discussed below.

1.909 Quality Review. Quality reviews were conducted prior to April 3, 1995 when the combination of the Quality Review Program and the PCPS Peer Review Program became effective and the Quality Review Program was renamed the "AICPA Peer Review Program".

1.910 Peer Review. Practice monitoring reviews administered after April 3, 1995 by state CPA societies under the guidance of the AICPA's Peer Review Board are called peer reviews. Such peer reviews also include reviews conducted pursuant to the membership requirements of the Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms. In addition, peer reviews include those conducted pursuant to the voluntary practice monitoring program administered by the SEC Practice Section (SECPS) of the AICPA's Division for CPA Firms. Reviews of PCPS and SECPS firms go beyond an evaluation of the profession's required quality control standards by also evaluating a firm's compliance with the membership requirements of the PCPS or the SECPS.

1.911 Off-Site Peer Review. An off-site peer review is a review that PRP and PCPS firms can elect if they issue compilation or review reports but perform no audits. Off-site reviews, however, are not available to SECPS member firms. In an off-site peer review, the reviewer reads only the financial

statements of selected clients and the accountant's compilation or review report, together with certain information that the reviewed firm provides.

1.912 Committee-Appointed Review Team (CART). A review team appointed directly by the state CPA society administering the review conducts a CART peer review. A review team appointed directly by the SECPS Peer Review Committee conducts a CART SECPS peer review. In either case, the "team" for a review of a small firm will often consist of only one person (the team captain).

1.913 Firm-on-Firm Review. In a firm-on-firm review, the firm being reviewed hires another CPA firm to conduct the review, subject to the approval of the appropriate administering entity.

1.914 Association Review Team. An association of CPA firms may be authorized to sponsor and conduct peer reviews. If your firm is a member of a CPA association that qualifies as an authorized sponsor, you may elect to have a review team appointed by your association conduct your peer review under the supervision of the entity administering your review (your state CPA society or the AICPA's SECPS).

1.915 Administering Entity. For PCPS and PRP firms, the administering entity is the state CPA society that administers, evaluates, and approves your firm's peer review. A listing of state societies is at section 1.928.

1.916 If your firm belongs to the SECPS, your administering entity is the AICPA's Division for CPA Firms.

1.917 Positive Enforcement Programs. Positive enforcement programs are generally mandatory programs initiated by state boards of accountancy. These programs often have statutory enforcement provisions. The trend is for state boards to initiate such programs.

1.918 The National Association of State Boards of Accountancy (NASBA) defines "positive enforcement" as "the process of monitoring the work products of practice units in order to monitor the quality of financial reporting." NASBA considers a state board of accountancy to have a positive enforcement program if it either (1) reviews publicly available financial statements and reports thereon or (2) requires practice units to submit financial statements and reports thereon to it for review.

1.919 Accounting and Auditing Practice. This phrase has several slightly different, but basically similar, meanings, depending on the context in which it is used.

1.920 SQCS No. 1 Definition. In a generic sense, an accounting and auditing practice is one that issues any type of reports on financial statements for clients. SQCS No. 1 uses the phrase "accounting and auditing and review services for which professional standards have been established." SQCS No. 1 *permits* quality control standards to be applied to other areas, such as tax services or management advisory services, but it specifically makes application optional, except to the extent that the services are provided as a part of auditing and accounting services.

1.921 Peer Review Definition. For peer review purposes, an accounting and auditing practice is one that audits, reviews, or compiles historical or prospective financial statements for clients, other than the

planning-type presentations of personal financial information described in SSARS No. 6. An accounting and auditing practice is defined in the AICPA's *Standards for Performing on Peer Review*[.30] as:

[A]ll auditing, review, and compilation services covered by Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statement on Standards for Attestation Engagements *Financial Forecasts and Projections*, and standards for financial and compliance audits contained in *Government Auditing Standards* issued by the U.S. General Accounting Office (the Yellow Book).

1.922 SECPS Definition. For SECPS peer review purposes, an accounting and auditing practice is essentially defined by the SECPS in the same way as noted above. The official definition in the *SEC Practice Section Reference Manual* (Section 2000.04, footnote 2) is:

[A]ll auditing, and all accounting, review, and compilation services covered by generally accepted auditing standards, standards for accounting and review services, financial forecasts and projections and proforma financial information sections of the standards for attestation engagements, and *Government Auditing Standards* issued by the U.S. General Accounting Office (the Yellow Book).

1.923 The literature makes it clear that a peer review does not cover tax services and management advisory services, except to the extent that these services are associated with financial statements or relate to compliance with SECPS membership requirements. Accounting work related to tax provisions and tax accruals that are contained in financial statements *is* included in your firm's peer review.

1.924 Professional Personnel. For peer review purposes, all employees who are CPAs, or who are expected to attain that designation during their careers, are considered to be professionals.

1.925 One gray area is the treatment of a full-charge paraprofessional who is fully capable of preparing financial statements but who is not attempting to become a CPA. As a practical matter, the authors recommend that you treat anyone who generates financial statements or performs other professional work as a professional.

Comparison of Peer Review Programs

1.926 The following chart gives you a quick-reference basis for comparison of reviews of PRP firms, PCPS firms, and SECPS firms. An "X" under the column for the particular review program indicates that the feature described pertains to that program.

	PRP	PCPS	SECPS
AICPA-administered			x
Administered by a state CPA society	x	x	
Results are confidential	x		

(Continued)

Results are on public record		x	x
Reports are subject to public oversight			x
Membership requirements are reviewed		x	x
Review must be completed within 18 months after	x	x	
Review must be completed within one year after joining			x
On-site peer review is always required			x

Comparison of PCPS and SECPS Membership Requirements

1.927 The following chart gives you a quick-reference basis of comparison.

Summarized PCPS Membership Requirements	Summarized SECPS Membership Requirements
Ensure that 66⅔ percent of the owners of the firm are CPAs and that all owners residing in the United States and eligible for AICPA membership are members.	Ensure that a majority of the owners of the firm are CPAs and that all owners residing in the United States and eligible for AICPA membership are members.
Adhere to the quality control standards established by the AICPA.	Adhere to the quality control standards established by the AICPA.
Have, and pay for, a peer review every three years. The first peer review must be completed within 18 months of the date the firm joins the PCPS.	Have, and pay for, a peer review every three years. The first peer review must be completed within one year from the date the firm joins the SECPS.
Ensure that all professionals, including non-CPAs, take part in at least 120 hours of qualifying CPE every three years, but not less than 20 hours every year.	Ensure that all professionals, including non-CPAs, take part in at least 120 hours of qualifying CPE every three years, but not less than 20 hours every year. Effective January 1, 1995, professionals in SECPS firms who devote at least 25% of their time to audit, review, or other attest engagements (excluding compilations) or have supervisory or review responsibilities for such engagements must obtain 40% of their required CPE hours in accounting and auditing subjects.
	Establish policies and procedures for a second partner concurring review of the audit report and financial statements for SEC engagements.

Summarized PCPS Membership Requirements	Summarized SECPS Membership Requirements
	Assign a new audit partner to be in charge of each SEC engagement after seven consecutive years, and prohibit the incumbent partner from returning to in-charge status for a minimum of two years. This requirement does not apply to firms with fewer than five SEC audit clients and fewer than 10 partners.
File an informational annual report with the PCPS every year. This is a short questionnaire that takes only a few minutes to complete each year.	File an informational annual report with the SECPS every year. This is a slightly expanded version of the short questionnaire that is required by the PCPS.
	Adhere to the AICPA's Code of Professional Conduct and <i>Statements on Standards for Management Advisory Services</i> dealing with independence in performing management advisory services for SEC audit clients. Refrain from performing certain specified services for SEC audit clients that are inconsistent with the firm's responsibilities to the public.
	Report annually to the audit committee or board of directors of each SEC audit client regarding management advisory services performed.
	Report to the audit committee or board of directors of each SEC audit client regarding accounting and reporting disagreements with management.
Pay annual dues (presently \$25 per CPA, up to a maximum of \$500).	Pay annual dues (presently \$19 per professional staff member, with a maximum of \$750 for firms with fewer than five SEC clients). Minimum dues are \$250 per year.
Agree to comply with PCPS rules and any sanctions that may be imposed upon the firm.	Agree to comply with SECPS rules and any sanctions that may be imposed upon the firm.
	Communicate in writing the broad principles that influence the firm's quality control and operating policies and procedures.
	Report to a quality control inquiry committee regarding litigation or investigations alleging deficiencies in the audit of a present or former SEC client.

CPA Societies

1.928 The AICPA Peer Review Program will be locally administered in most states.

<i>Name</i>	<i>Mailing Address</i>	<i>Telephone</i>
Alabama Society of CPAs	P.O. Box 4187 Montgomery, AL 36103	(205) 834-7650
Alaska Society of CPAs	P.O. Box 100675 Anchorage, AK 99510	(907) 337-4334
Arizona Society of CPAs	426 N. 44th St., Ste. 250 Phoenix, AZ 85008-6501	(602) 273-0100
Arkansas Society of CPAs	970 Plaza West Building McKinley & Lee Streets. Little Rock, AR 72205-8320	(501) 664-8739
California Society of CPAs	275 Shoreline Dr. Redwood City, CA 94065-1412	(415) 594-1717
Colorado Society of CPAs	7720 E. Belleview Ave., #46B Englewood, CO 80111	(303) 773-2877
Connecticut Society of CPAs	179 Allyn St., Ste. 501 Hartford, CT 06103-1418	(203) 525-1153
Delaware Society of CPAs*	28 The Commons 3520 Silverside Rd. Wilmington, DE 19810	(302) 478-7442
District of Columbia Institute of CPAs	2100 Pennsylvania Ave., N.W. Ste. 240 Washington, DC 20037	(202) 659-9183
Florida Institute of CPAs	P.O. Box 5437 Tallahassee, FL 32314-5437	(904) 224-2727
Georgia Society of CPAs	3340 Peachtree Rd., N.E. Ste. 2750, Tower Place Atlanta, GA 30326	(404) 231-8676
Hawaii Society of CPAs	P.O. Box 1754 Honolulu, HI 96806	(808) 537-9475; (808) 523-3097

<i>Name</i>	<i>Mailing Address</i>	<i>Telephone</i>
Idaho Society of CPAs	323 W. Idaho, Ste. One Boise, ID 83702	(208) 344-6261
Illinois CPA Society	222 S. Riverside Plaza, 16th Fl. Chicago, IL 60606	(312) 993-0393
Indiana CPA Society	P.O. Box 68847 Indianapolis, IN 46268	(317) 872-5184
Iowa Society of CPAs	4000 Westown Pkwy. West Des Moines, IA 50265	(515) 223-8161
Kansas Society of CPAs	P.O. Box 5654 Topeka, KS 66605-0654	(913) 267-6460
Kentucky Society of CPAs	310 W. Liberty St., Rm. 604 Louisville, KY 40202	(502) 589-9239
Society of Louisiana CPAs	2400 Veterans Blvd., Ste. 500 Kenner, LA 70062	(504) 464-1040
Maine Society of CPAs**	Box 7406 DTS Portland, ME 04112	(207) 772-9639
Maryland Association of CPAs	P.O. Box 484 Lutherville, MD 21093	(301) 296-6250
Massachusetts Society of CPAs	105 Chauncy St., 10th Fl. Boston, MA 02111	(617) 556-4000
Michigan Association of CPAs	P.O. Box 9054 Farmington Hills, MI 48333	(313) 855-2288
Minnesota Society of CPAs	N.W. Financial Center, Ste. 1230 7900 Xerxes Ave., S. Minneapolis, MN 55431	(612) 831-2707
Mississippi Society of CPAs	P.O. Box 16630 Jackson, MS 39236	(601) 366-3473
Missouri Society of CPAs	P.O. Box 27342 St. Louis, MO 63141	(314) 997-7966

(Continued)

<i>Name</i>	<i>Mailing Address</i>	<i>Telephone</i>
Montana Society of CPAs	P.O. Box 138 Helena, MT 59624-0138	(406) 442-7301
Nebraska Society of CPAs	635 S. 14th St., Ste. 300 Lincoln, NB 68508	(402) 476-8482
Nevada Society of CPAs	5270 Neil Rd., Ste. 102 Reno, NV 89502	(702) 826-6800
New Hampshire Society of CPAs	Three Executive Park Dr. Bedford, NH 03102	(603) 622-1999
New Jersey Society of CPAs	425 Eagle Rock Ave. Roseland, NJ 07068	(201) 226-4494
New Mexico Society of CPAs	300 San Mateo, N.E., Ste. 101 Albuquerque, NM 87108-1520	(505) 262-1926
New York State Society of CPAs	530 Fifth Ave. New York, NY 10036-5101	(212) 719-8300 (800) 633-6320
North Carolina Association of CPAs	P.O. Box 80188 Raleigh, NC 27623	(919) 469-1040
North Dakota Society of CPAs	Box 8104, University Station Grand Forks, ND 58202	(701) 777-3869
Ohio Society of CPAs	P.O. Box 1810 Dublin, OH 43017	(614) 764-2727
Oklahoma Society of CPAs	128 W. Hefner Rd. Oklahoma City, OK 73114-6629	(405) 478-4484
Oregon Society of CPAs	10206 S.W. Laurel St. Beaverton, OR 97005	(503) 641-7200
Pennsylvania Society of CPAs	1608 Walnut St., Third Fl. Philadelphia, PA 19103	(215) 735-2635
Colegio de Contadores Publicos Autorizados de Puerto Rico	Apartado Postal 71352 San Juan, PR 00936-1352	(809) 754-1950
Rhode Island Society of CPAs**	One Franklin Square Providence, RI 02903	(401) 331-5720

<i>Name</i>	<i>Mailing Address</i>	<i>Telephone</i>
South Carolina Association of CPAs	570 Chris Dr. West Columbia, SC 29169	(803) 791-4181
South Dakota CPA Society	P.O. Box 533 Rapid City, SD 57709	(605) 341-1876
Tennessee Society of CPAs	P.O. Box 150549 Nashville, TN 37215	(615) 269-3478
Texas Society of CPAs	1421 W. Mockingbird Lane Suite 100 Dallas, TX 75247-4957	(214) 689-6000
Utah Society of CPAs***	455 E. 400 South, Ste. 202 Salt Lake City, UT 84111	(801) 359-3533
Vermont Society of CPAs**	Three Parkside Dr. Montpelier, VT 05602	(802) 229-4939
Virginia Society of CPAs	P.O. Box 31635 Richmond, VA 23294-1635	(804) 270-5344
Washington Society of CPAs	902 140th Ave., N.E. Bellevue, WA 98005	(206) 644-4800
West Virginia Society of CPAs	P.O. Box 1142 Charlestown, WV 25324	(304) 342-5461
Wisconsin Institute of CPAs	P.O. Box 1010 Brookfield, WI 53008-1010	(414) 785-0445
Wyoming Society of CPAs	1910 Thomes Ave. Cheyenne, WY 82001	(307) 634-7039

* Administered by the Pennsylvania Society of CPAs

** Administered by the New Hampshire Society of CPAs

*** Administered by the Texas Society of CPAs

**AICPA Quality Control Directory**

1.929 The following AICPA personnel are available to assist you on quality control and practice monitoring questions:

<i>Topic</i>	<i>Contact</i>	<i>Telephone</i>
PCPS — Membership	David Handrich	(212) 596-6145; (212) 596-6144
SECPS — Membership	Bruce Brasell	(212) 596-6134
AICPA Peer Review Program		(201) 938-3030
Technical Accounting and Auditing Matters	AICPA Technical Information Service	(800) TO-AICPA (862-4272)
Library Assistance Information Service	Library	(800) TO-AICPA (862-4272)
Professional Ethics and Independence	Professional Ethics Division	(800) TO-AICPA (862-4272)

CHAPTER 2

**DESIGN AND IMPLEMENTATION
OF YOUR FIRM'S QUALITY CONTROL SYSTEM**

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CHAPTER 2

DESIGN AND IMPLEMENTATION OF YOUR FIRM'S QUALITY CONTROL SYSTEM

2.000 OVERVIEW

2.001 Chapter 1 explained what quality control is and why it exists. But, as that introductory discussion recognized, your practice is unique. It reflects your firm's specific client mix, your personal preferences and philosophies, and your way of doing business. The best, and most cost-beneficial, quality control system is the one that you have customized to meet the unique needs of your own practice. Just as a custom-made suit fits better than one that you buy off the rack, a properly designed quality control system will feel more comfortable than one that you merely copy out of a book. In fact, off-the-rack is not even an available option in this situation.

2.002 As you design your firm's quality control system, you will have to make a number of decisions, some in response to the American Institute of Certified Public Accountants' (AICPA's) programs and others dictated by common sense. To do so, you should:

- Stop and think about your firm's unique situation (section 2.100),
- Develop a design and implementation timetable (section 2.200), *and*
- Develop, implement, and test your firm's quality control system (section 2.300).

Practice Tip:

You probably already have some quality control system in place. Often, what are most needed are refinements to the existing system and compliance documentation (see detailed discussion in Chapters 3–11 and summary in Chapter 12).

System of Quality Control

2.003 Your firm must have some sort of quality control system, even if the firm is so small that its system need not be formal. Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, requires the quality control system to be:

1. Appropriately comprehensive *and*
2. Suitably designed for the nature of your practice.

2.004 Your firm's system must provide reasonable assurance that the firm will conform to professional standards. In particular, SQCS No. 1 requires your firm to:

1. Establish policies and procedures for each of the nine elements of quality control as they apply to its practice (section 2.102),
2. Communicate these policies and procedures to its personnel (although SQCS No. 1 does not differentiate between professional and other personnel, many CPA firms interpret it to mean *all* personnel), *and*
3. Monitor the effectiveness of its policies and procedures.

2.100 THINKING ABOUT YOUR FIRM'S UNIQUE SITUATION

2.101 Within the framework of the nine elements of quality control contained in SQCS No. 1, you have a great deal of latitude in designing your firm's quality control system and customizing it to fit your own needs. Thus, before you do anything else, you have to answer a number of questions in order to define those needs:

1. Which quality control elements apply to your practice?
2. How complex a system do you need?
3. What should you put in writing?
4. Who is going to coordinate and enforce your effort?
5. What can you learn from other firms' mistakes?

Practice Tip:

When you design or revise your firm's quality control system, you should always ask yourself two key practical questions:

1. What are the minimum cost-effective quality controls that will assure your firm's compliance with professional standards?
2. What quality controls do you need to ensure that your practice is ready to handle future growth?

This chapter will help you to address these questions.

Which Quality Control Elements Apply to Your Practice?

2.102 SQCS No. 1 sets forth nine elements:

1. *Independence:* Regardless of how small your practice may be, you must establish policies and procedures to provide reasonable assurance that all persons in your firm, at all levels, maintain independence in fact and in appearance with regard to your financial statement clients. (See Chapter 3.)
2. *Consultation:* Consultation refers to the guidance you should seek from authoritative sources, such as appropriate professional literature or fellow professionals who might be more knowledgeable about a particular subject than you are. Your consultation policies and procedures must reasonably ensure that you and your staff will seek assistance to the extent required. (See Chapter 4.)
3. *Supervision:* Supervision is probably the most important of all of the quality control elements. You must establish and comply with policies and procedures for the planning, conduct, supervision, and review of accounting and auditing work at all levels to provide reasonable assurance that all work performed meets your firm's, and the profession's, standards. You should also document your entire planning process on financial statement engagements. (See Chapter 5.)
4. *Professional development:* In the context of your quality control system, the professional development element means that you must be careful and know your limitations. Your professional development policies and procedures must reasonably ensure that your professional personnel will have the knowledge necessary to fulfill the responsibilities that you assign to them. (See Chapter 6.)
5. *Acceptance and continuance of clients:* As part of your quality control system, you must establish and comply with policies and procedures that reasonably ensure that the management and ownership of the clients for which you perform financial statement engagements possess the requisite integrity. You should also be careful about accepting high-risk clients, such as financial institutions, municipalities, oil and gas companies, companies in high-technology industries, and broker/dealers. (See Chapter 7.)
6. *Hiring:* Your hiring policies and procedures must reasonably ensure that you employ personnel who possess the skills and characteristics that enable them to perform their duties competently. (See Chapter 8.)
7. *Assigning personnel to engagements:* You must establish policies and procedures to provide reasonable assurance that persons who work on an engagement have the degree of technical training and proficiency required under the circumstances. However, this element is typically not a problem area for small firms. (See Chapter 9.)
8. *Advancement:* Your advancement policies and procedures must reasonably ensure that the employees you select for advancement have the qualifications necessary to fulfill the responsibilities they will assume. (See Chapter 10.)
9. *Inspection:* Under normal circumstances, your firm will have a peer review once every three years. For at least the two interim years, when your firm is not being reviewed, you need to establish inspection policies and procedures that reasonably ensure that your quality control system is still working properly. (See Chapter 11.)

Practice Tip:

The AICPA's practice monitoring programs have formed a Joint Task Force on Quality Control Standards in conjunction with the Auditing Standards Board. The task force is studying possible changes to Statement on Quality Control Standards No. 1 and its interpretations. Recommendations include changing the existing quality control element of inspection to "monitoring" (monitoring activities include, but are not limited to inspection), combining the existing elements of hiring, assignment of personnel, professional development, and advancement into a single "personnel issues" quality control element, and combining the existing supervision and consultation elements into "engagement performance." The authors believe that, if adopted, such changes will clarify and streamline the existing pronouncement without necessitating any material changes in the quality control systems that practicing firms have already implemented. The authors also believe that any major revisions of Statement on Quality Control Standards No. 1 and its interpretations will probably need to go through the profession's full exposure draft process before such revisions can be adopted. An exposure draft of an amendment to SCQS No. 1 is expected to be issued in the fall of 1995. In the meantime, SCQS No. 1, in its original form, should still be regarded as the current authoritative professional standard in the area of quality control.

2.103 If your firm has 10 or fewer professionals, reviews performed under the AICPA Peer Review Program will *ordinarily* focus only on the first four of these nine elements of quality control. If your firm belongs to the SECPS, its compliance with six elements will be reviewed.

Practice Tip:

It is important for you to understand that even a small firm having a peer review should consider, to the extent that they apply to the practice, all nine elements of quality control. In fact, your firm's peer reviewer can decide to include one or more of the additional elements as part of the review if there appears to be a reason to do so. These additional elements are not a mandatory part of a small firm's review because in most cases, the close supervision that the proprietor or the partners provide means that compliance with these elements is inherent in the firm's ordinary activities.

Related Ethical Considerations

2.104 Not only is quality control a matter of professional standards, but it is also a matter of professional ethics. ET section 101 of the AICPA Code of Professional Conduct is entitled "Independence" (see further discussion in Chapter 3). In addition, portions of ET 201 ("General Standards") are directly related to another seven of the nine quality control elements. (The only quality control element that is not covered in the Code of Professional Conduct is inspection.)

2.105 ET 201.01A says that a member shall "[u]ndertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence." The following quality control elements address this ethical requirement:

1. Consultation,
2. Supervision,
3. Professional development,
4. Acceptance and continuance of clients,
5. Hiring,
6. Assigning personnel to engagements, *and*
7. Advancement.

2.106 ET 201.01B says that a member shall "[e]xercise due professional care in the performance of professional services." The following quality control elements address this ethical requirement:

1. Consultation *and*
2. Supervision.

2.107 ET 201.01C states that a member shall "[a]dequately plan and supervise the performance of professional services." The following quality control elements address this ethical requirement:

1. Supervision,
2. Assigning personnel to engagements, *and*
3. Advancement.

How Complex a System Does Your Firm Need? Some Factors to Consider

2.108 Obviously, if you are engaged in a local practice, your firm's quality control system will be quite different than the system of a national or regional firm. Less obviously, your firm's system will not be exactly the same as that of even your closest competitor down the street. SQCS No. 1 fully recognizes that "the nature and extent of a firm's quality control policies and procedures depend on a number of factors." The enumerated factors include:

- Firm size,
- Nature of practice,
- Organizational structure, *and*
- Number, location, and autonomy of offices.

2.109 SQCS No. 1 also mentions "the degree of operating autonomy allowed ... personnel and ... operating offices," and "appropriate cost-benefit considerations." Because of the variety of factors that can significantly affect the nature and scope of your quality control system, it is impossible to prescribe a single cookbook quality control system that would be appropriate, or even useful, for all CPA firms.

2.110 Some typical relationships of various firm factors to the scope of quality control systems are explained below. (See also the Checklist to Determine Scope of Quality Control System in section 2.602.)

Practice Tip:

Your goal is to support your practice properly at a cost that is reasonable in terms of both time and dollars. At the same time, it is important not to stifle your firm's future growth by designing a system that is adequate for today but not for changes that you reasonably anticipate. You should seriously consider implementing a quality control system that will be sufficient for a slightly larger practice than your present one. It is far better for your firm to grow into its system than to be cramped almost from the start. For example, if your firm has only six or seven professionals today, but hopes to be hiring more in the future, you might design a quality control system intended for a firm of more than 10 professionals. Otherwise your firm may soon outgrow its system and have to spend the time and money necessary to revise it. Similarly, if your firm has only a tax practice today, but anticipates reporting on financial statements in the future—or if it has no auditing practice right now, but anticipates having one soon—you should design the system accordingly.

Firm Size

2.111 The smaller your firm is, the closer you and your partners, if any, are likely to be to its daily operations and decision-making process. Conversely, larger firms tend to be more decentralized. Accordingly, large firms need more explicit and formal policies and procedures.

Nature of Practice

2.112 If your practice is primarily audit-oriented, its needs will differ from those of a firm that generally issues only compilation reports. Similarly, if your firm has clients in specialized industries, its requirements must be responsive to that part of the practice. For example, if your firm's clients include banks, its research materials and consultation network should include literature on and contacts in the banking industry, and its CPE mix should include relevant courses on financial institutions. (See Chapters 4 and 6 for further discussions of consultation and professional development, respectively.)

Organizational Structure

2.113 If your firm's decision-making process rests principally with one person, or with a small group of people who work together closely, its quality control system can omit some of the procedures that might otherwise be necessary. If, for example, all partners in a small firm are in the same office and are, as a group, integrally involved in the acceptance of new clients, they may have little need for sophisticated policies and procedures in that area, other than, perhaps, a means of documenting decisions. In a larger firm, where the partners cannot all be personally involved in each and every decision, a more formal system is necessary.

Number, Location, and Autonomy of Offices

2.114 If your firm has several offices, it will need a more comprehensive set of policies and procedures—particularly if the offices are far apart—than a similarly sized firm that operates out of one office will need. The operating autonomy of each office is also an important consideration.

Other Factors

2.115 In designing your firm's quality control system, also consider factors such as:

1. Whether your firm is a member of the PCPS or SECPS (in which case it will have to comply with the membership requirements of the appropriate section, as set forth in section 1.927),
2. The complexity and sophistication of your firm's clients (as complexity and sophistication increase, so does the need for formal quality control), *and*
3. The size and technical abilities of your firm's staff.

Summary of Impact of Firm Factors

2.116 The following list sets forth some typical relationships of various firm factors to the scope of quality control systems. Take a few minutes to review these factors and to reflect on how they relate to your own practice. [Also complete the Checklist to Determine Scope of Quality Control System (section 2.602).]

<i>Factors Indicating Need for More Formal Quality Control System</i>	<i>Factors Indicating Need for Less Formal Quality Control System</i>
Larger practice	Smaller practice
Many partners	Sole proprietor or few partners
Multiple offices	Single office
Accounting and auditing-oriented mix	Tax or management advisory service-oriented mix
Practice includes audits	Few or no audits performed
Inexperienced staff	Experienced staff
Offices and staff have operating autonomy	Offices and staff are closely monitored
Specialized industries	No specialized industries
On-site peer review scheduled	Off-site peer review scheduled

What Should You Put in Writing?

2.117 Your firm's quality control document is a written summary of its quality control system. A formal quality control document is *not* required. At a minimum, however, you must prepare a summary using a pre-printed AICPA peer review questionnaire before your firm has its on-site peer review. (See the AICPA Peer Review Program Questionnaires in section 2.700 of this chapter.) In many cases, you can summarize your firm's policies and procedures directly on these questionnaires, expanding on them where you deem it necessary to do so. Nevertheless, the authors believe you should consider preparing at least a partial quality control document, particularly for the four quality control elements that are always reviewed—that is, (1) independence, (2) consultation, (3) supervision, and (4) professional development. This document would set forth affirmatively, in simple language, the policies and procedures that your firm has adopted. (Sample text for each element is found in the "Your Quality Control Document" subsection of each of Chapters 3–11.)

2.118 As you may have already noticed, it is sometimes difficult to tell exactly where one quality control element ends and another begins. Some of the elements — such as hiring, professional development, assigning personnel to engagements, supervision, and advancement — are closely interrelated. A quality control document helps you put the pieces together into a good overall system that will aid you in producing work in which you can take pride. Creating such a document forces you to become keenly aware of the intricacies and details of the quality control process. Your firm's quality control document will also make it much easier to train new personnel because important policies and procedures will be clearly spelled out, not left to individual interpretation.

Practice Tip:

As the authors previously pointed out, the AICPA practice monitoring programs do not require a formal quality control system. But remember that, even if your firm is small, you still need to consider each of the quality control elements to the extent they apply to your practice. Although your documentation of compliance with some elements may not be formal, you cannot ignore them. The sample policies and procedures contained in Chapters 3–11 may be helpful when you address the various quality control elements.

Who is Going to Coordinate and Enforce Your Firm's Effort?

2.119 One item that must be stressed, and that is too often overlooked, is the importance of *leadership*. Your firm's quality control system probably will not work unless you and the other top people in your firm demonstrate a genuine commitment to developing, implementing, and following it. Your firm must also provide centralized responsibility and communicate its policies clearly to all personnel.

Centralize Responsibility in a Quality Control Partner

2.120 It is important for your staff to know who has authority for (and can answer questions about) your firm's quality control system. Accordingly, the authors recommend that your firm designate one person, preferably a partner (or yourself, if you are a sole proprietor), to be in charge of quality control, and that the firm should give this person the *authority* to carry out this responsibility. This quality control partner should be responsible for all aspects of quality control, from design through implementation to ongoing monitoring of compliance with the system and dealing with your firm's peer review team. Your quality control partner must be a good administrator as well as someone who is technically proficient in accounting and auditing (in a small firm, your managing partner might also serve as your quality control partner.)

Practice Tip:

It is crucial that the person selected to design and implement your quality control system be truly committed to the project and given sufficient authority to make your firm's program work.

(To learn how to implement the system, see sections 2.316–2.319.)

What Can You Learn From Other Firms' Mistakes?

2.121 Knowing what to avoid will actually help you design your firm's quality control system. Most deficiencies found in actual peer reviews have been supervision-related and often related to problems in documentation of compliance with audit standards. (See section 2.700. The issues these deficiencies raise are addressed more thoroughly in Chapters 3–12.)

2.200 ESTABLISH A QUALITY CONTROL TIMETABLE

2.201 The authors recommend that, generally, the design and implementation of a meaningful quality control system should begin well before the date of your firm's first peer review. That is why the practice monitoring programs allow your firm 12 to 18 months before its first peer review, depending upon the program. Even if your firm has 10 or fewer professionals and is anticipating a peer review that focuses on only four of the quality control elements, you should still allow yourself sufficient time to get ready. The design and implementation of an effective quality control system can take from a few days to several months. So you should start designing your firm's quality control system today. Ideally, you should have the system in place and yielding reliable results *before* the start of your firm's review year (that is, the 12-month period from which the review sample will be drawn).

What if You Do Not Have Time to Complete Implementation?

2.202 Because your firm's peer review will cover a 12-month period, it may encompass some engagements that you completed before your firm fully implemented its quality control system. Your peer reviewer's evaluation of problems noted in engagements performed before you implemented your quality control system may include an assessment of whether your new system would have mitigated the problem, had it been in effect at the time you conducted the engagement. The emphasis will be on whether the engagement conformed to professional standards.

2.203 Your firm's peer review team must take additional action if it appears that a report your firm prepared must be recalled or that your actions do not meet the standards set forth in Statement on Auditing Standards No. 46 (SAS No. 46), *Consideration of Omitted Procedures After the Report Date* or section 561 of SAS No. 1, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Even if the report that was issued is satisfactory, additional action must also be taken if the engagement workpapers do not provide evidence that the firm adhered to the applicable authoritative standards. If such problems are noted during a peer review, the team captain must document the matter, including your firm's plans for corrective action and whether he or she agrees with that action. Failure to remedy substandard work of this type may be grounds for termination of your firm's enrollment in the Peer Review Program or suspension or expulsion of your firm from the PCPS or SECPS.

2.204 Extensions may also be available under limited circumstances, but failure to have your firm's quality control system in place is *not* grounds for an extension (see section 1.545).

Practice Tip:

Do not assume that your firm's quality control system will not be part of your peer review simply because the system was not fully in place. SQCS No. 1 has now been in effect for almost 20 years, and professional standards clearly require that appropriate quality control procedures be followed in every financial statement engagement, regardless of whether the procedures are formalized.

2.300 DEVELOPMENT, IMPLEMENTATION, AND TESTING OF YOUR FIRM'S QUALITY CONTROL SYSTEM

2.301 Once you have formed a basic picture of what you are doing and established a workable timetable, you must actually develop and implement your firm's system. Development and implementation is a process that involves five stages. (See also the Quality Control System Design and Implementation Checklist in section 2.603 of this chapter.)

1. Gather the necessary information and expertise;
2. Evaluate what you have and develop what else you need;
3. Implement and follow your firm's new policies and procedures;

4. Inspect and analyze your results; *and*
5. Revise and finalize your firm's system.

Gather the Necessary Information and Expertise

2.302 You will have to look at what your firm already has in place, review the professional literature, and decide what help you will need in creating (or revising) a formal quality control system.

Practice Tip:

Don't actually change anything at this stage—just gather the facts and carefully think about them. Be sure at this point that you really understand your firm's practice and its philosophy and professional objectives. You must fully comprehend them in order to effectively develop a quality control program that addresses your firm's true needs.

Gather All Existing Written Policies and Procedures

2.303 As previously noted, your firm probably already has some quality control system in place. Your first step is to gather any written policies and procedures that the firm already has; you may discover that you have more than you realized. If your firm uses checklists and forms, or write memoranda to the staff about administrative or procedural matters, be sure to include those items in the database you are creating. The end result of this step should be an inventory of which areas are already covered by some sort of written policies and procedures and a summary of what quality control elements your firm's policies and procedures do not yet cover.

Practice Tip:

You will definitely find it helpful to organize your firm's existing policies and procedures in a looseleaf binder so that you can readily revise and add material. Also, date your materials so that you can always identify the most current version after you make revisions.

Review Relevant Professional Literature

2.304 Resist the temptation to jump in blindly. Before you start creating a quality control system, you should feel comfortable with your knowledge of exactly what is required and what will best serve your practice. Although this Manual is designed to guide you through the quality control process, you should also be sure to read the actual authoritative AICPA pronouncements that apply to your practice, such as:

- SQCS No. 1 (QC section 10 of *AICPA Professional Standards*),
- Interpretations of SQCS No. 1,

- Quality Control Policies and Procedures for CPA Firms (QC section 90 of *AICPA Professional Standards*), and
- Appropriate standards for the review your firm will be having, such as *Standards for Performing and Reporting on Peer Reviews* (for PCPS and PRP firms), or the *SEC Practice Section Reference Manual* (for SECPs firms).

2.305 The authors highly recommend that you read and understand all relevant chapters in the manuals before you start designing your firm's quality control system.

Consider Whether Your Firm Needs to Hire Additional Technical Personnel

2.306 Some CPA firms are understaffed and, therefore, already need additional personnel. Others are growing so fast that they will need more people soon. If your firm falls into either of these categories, you might look for someone who already has the technical proficiency and experience necessary to help you design and implement your quality control system. Hiring such a person will keep other personnel available for whatever they do best. However, you might also consider using an outside consultant.

Determine Whether Using an Outside Consultant Would Be Beneficial

2.307 Many CPA firms are finding that their personnel have neither the time nor the expertise to evaluate the firm's needs and to design an appropriate quality control system. It is easy to understand how practitioners who are already overburdened with client work and with just trying to keep up with the standards overload, lack the time and expertise needed to design a new quality control system. If your firm falls into this category, you may find it cost-effective to engage an outside consultant.

2.308 The primary benefit of using an outside consultant is that you keep yourself and your staff available for clients' work, which is the reason why you are in business in the first place. Using a consultant is also helpful in preventing a common pitfall—allowing the development of your quality control system to take second place to client work or to routine but necessary firm administration. Additionally, a consultant can often design your firm's quality control system much more quickly than you can.

2.309 If you decide to engage an outside consultant, you may want to obtain the latest copy of the AICPA's *Firm-on-Firm Review Directory*, which lists, by state and by firm size, CPA firms that have expressed an interest in conducting peer reviews. In addition, some state CPA societies, such as Texas, publish directories on a statewide or regional basis.

Consider Enrolling in Appropriate CPE Courses

2.310 The AICPA and state CPA societies, as well as private vendors, offer seminars and self-study materials that can help you design your quality control system and prepare for your review (as well as become qualified to review other practitioners).

2.311 Self-study courses available through the AICPA include:

- *Preparing for Peer Review*
- *Peer Review for Medium and Small Firms (MicroMash)*

Evaluate What You Have and Develop What Else You Need

2.312 Once you have collected the policies and procedures your firm already has in place and have obtained the necessary design expertise, you must begin to develop the system that your firm will need to pass its peer review.

2.313 First, compare your firm's existing policies and procedures to minimum documentation (see Chapter 12) and the firm's actual needs. Based on the facts you have obtained, as well your understanding of what an adequate quality control system should encompass for your particular firm, you should outline the general policies and procedures that you believe are necessary for a satisfactory quality control system for your specific practice. Then, create or acquire new forms and checklists as needed; also set tentative responsibilities for the implementation and evaluation of your firm's quality control system. Be sure that your partners and key personnel are aware of the policies and procedures that you are drafting and that they agree with them conceptually.

Practice Tip:

The materials in Chapters 3–11 (which discuss the nine quality control elements and how to address them) and in Chapter 12 (which summarizes minimum documentation recommendations) will help you to complete this step.

Allow yourself sufficient time to think through the items you have outlined and to see how they fit together into the overall plan.

Do not include unnecessary policies and procedures in your firm's quality control system just for the sake of having them or because you think they "look good." Do not arbitrarily specify standards for your firm that materially exceed professional standards unless you realistically expect to be able to enforce such higher standards. *Otherwise, during your firm's peer review, your firm will be held accountable to the higher standard. Failure to understand this concept has caused some firms to be criticized for failing to comply with their own system of quality control, even though they were fully in compliance with all applicable required professional standards.*

Drafting Your Firm's Quality Control Document

2.314 Although your firm will be expected to document its compliance with the elements of quality control, it is not required to create a formal quality control document that actually states its policies and procedures. At a minimum, however, prior to an on-site peer review you must be prepared to answer

an AICPA questionnaire that summarizes your firm's quality control system (see the AICPA Peer Review Questionnaire in section 2.700 of this chapter). In many cases, you can summarize your policies and procedures directly on such a questionnaire, expanding on it only if you deem it necessary to do so. However, if there are more than just a few personnel in your firm, the authors recommend that you consider at least a partial quality control document, particularly for the four quality control elements that are always reviewed during peer reviews performed under the AICPA Peer Review Program. If your firm is a member of the SECPS, the document should cover the six elements that are always reviewed (see discussion in sections 2.102–2.103).

2.315 The AICPA questionnaires are organized by the nine functional quality control elements. If you supplement such a questionnaire with your firm's own memoranda and materials, or if you write your own formal quality control document, it is helpful to, likewise, arrange your materials according to the nine quality control elements.

Practice Tip:

Just as a looseleaf binder is invaluable for gathering your firm's underlying information and formulating its quality control policies and procedures, it is also an excellent way to keep the final quality control document up to date. From time to time you will want to revise or supplement your firm's existing policies and procedures. A looseleaf format can be readily edited, updated, and expanded as needed. Many firms provide all professional personnel with looseleaf policies and procedures binders—when revisions are necessary, only the new or revised pages need to be distributed, together with instructions about where to insert them in the binders and which existing pages, if any, to remove.

Implement and Follow Your Firm's New Policies and Procedures

2.316 If you have drafted clear, concise, and well-organized policies and procedures, implementation will mostly be a matter of motivating your personnel by communicating and demonstrating to them the benefits of a good quality control system (see Chapter 1, section 1.700).

2.317 Communicate. Understanding is essential to obtaining the support and the commitment of the people who will ultimately make your quality control system work or fail. People naturally stay within their own circle of comfort and are likely to resist change unless they see and understand why the changes are necessary. As discussed earlier, both leadership and a serious, demonstrated commitment to quality control at the top of the firm are crucial to enlisting the support that is needed at this stage. An important part of leadership is to keep your staff informed of your objectives and your progress.

2.318 As you develop and implement your firm's quality control system, it is a good idea to conduct one or more staff meetings and CPE programs to explain to your staff (including your support staff) what you are doing, why you are doing it, and why the firm is committed to quality in its practice. You may also wish to send a memorandum to your staff (see the Sample Memorandum to Staff Concerning Quality Control System in section 2.604 of this chapter).

2.319 Facilitate Staff Compliance. Each member of your professional staff should have a reference copy of your quality control document and any formalized quality control materials (checklists, forms, and the like) that you require your staff to use to document compliance. You should also make additional copies of your firm's quality control materials freely available. And you should be sure to stress quality control in your final review of all engagement files and reports.

Inspect and Analyze Your Results

2.320 As your firm begins to follow its new system, you must watch over it closely. SQCS No. 1 and authoritative interpretations of it require an annual inspection; you must review your quality control policies and procedures to ascertain whether your firm is effectively applying them. Ordinarily, you will perform your internal inspections in the interim years between peer reviews. However, it is also a good idea to perform a brief inspection as part of the implementation of your firm's quality control system. This inspection will help you evaluate whether the firm's system is working properly and efficiently and, consequently, will help you avoid unpleasant surprises during the actual peer review.

Practice Tip:

Be sure to set aside some time to evaluate your inspection findings critically and objectively and to compare them to your expected results.

2.321 You can accomplish your inspection in several ways:

1. You and your professional staff can conduct it;
2. You can arrange for "cross-inspection" with another CPA firm (that is, you inspect the other firm, and it reciprocates by inspecting your firm); *or*
3. You can engage an outside consultant or another CPA firm to inspect your firm.

Revise and Finalize Your Firm's System

2.322 After you have inspected your firm's quality control system and analyzed the results, set aside some more time to think about how to fine tune policies and procedures to rectify any problems that you uncovered during the inspection process. You may conclude that no further revisions are needed. But you should not be afraid to change things if you or any of your staff members see better or more efficient ways to accomplish your goals. If something is not working, this is the time to fix it. During this monitoring and motivational period, you may discover additional or different policies and procedures to implement, but you may also find and eliminate some unnecessary policies or procedures. If a procedure or form does not truly add to the integrity of the system or the work product, evaluate whether it is really needed.

2.323 You may have to repeat this review process. You might redesign and fine tune some parts of your firm's quality control system more than once. The second time, however, there should be far fewer items to reconsider.

2.324 Ideally, you should complete your fine tuning slightly more than one year before your firm's scheduled peer review. If you have to make major modifications to the system, consider conducting another brief inspection *during* your firm's review year to ensure that everything will be satisfactory when the on-site peer review team arrives or when you send the data to an off-site reviewer. Your firm's system should now be in, or close to, the final form that will be reviewed in your peer review.

2.325 If your firm conducts audits (or examinations of prospective financial statements), prepare for an on-site peer review. If your firm has no audit practice, prepare for an off-site peer review—unless your firm belongs to the SECPS. (The Quality Control System Maintenance Timetable in section 2.605 of this chapter will help you keep your firm's system in order during this period.)

Keep Your Staff Involved

2.326 Communication remains critical at this point. Your staff members will be frustrated and may even begin to question your sanity unless you forewarn them that some changes will be occurring as you tinker with your firm's quality control system.

Practice Tip:

Issue a series of memoranda to keep everyone constantly informed of decisions made, of changes to policies and procedures, and of how various parties may be affected. Explain the expected results.

Better yet, keep your staff actively involved in the process of design and implementation and let the process become a learning experience. Take staff members to lunch and discuss their reactions and ideas. You want more than a good quality control system—you also want an efficient system and a happy staff.

Consider Whether Outside Help Is Needed

2.327 Your inspection may have highlighted problems that you do not know how to correct efficiently. If this is the case, obtain some outside help as soon as possible (see sections 2.307–2.309).

Have a Consulting Review as a Trial Run

2.328 Confidential "no-risk" consulting reviews are available to help you assess your firm's quality control system and your readiness for a peer review. In a consulting review, an experienced reviewer will spend a day in your office examining your firm's quality control system and looking at selected workpapers and financial statements in order to help you pinpoint areas that need improvement. Only oral suggestions are made; there is no written report, so you cannot "fail" a consulting review.

2.329 Consulting reviews are offered by some state CPA societies through the peer review program and the AICPA's Division for CPA Firms, as well as on a firm-on-firm basis by many CPA firms who are qualified to conduct peer reviews. For firms of up to 20 professionals, the review involves one reviewer for one day and costs only \$700 per day plus expenses. As an added benefit, if your firm has a consulting

review and then joins the PCPS within one year after its consulting review, PCPS will refund 50% of the fee (excluding expenses), up to \$350. If your firm is already a PCPS member, it will be entitled to a similar refund provided that its PCPS membership is continuous from the date of the consulting review through the date of the first peer review.

Practice Tip:

The authors' experience has shown that a consulting review can be of enormous benefit to a firm that is preparing for its first review. We strongly urge you to schedule a consulting review well in advance of your firm's first formal peer review. This may be the most important thing you ever do to get ready. We also recommend that firms that have been previously reviewed consider the benefits of having a consulting review about a year before their next peer review.

Use an Outside Consultant

2.330 An outside consultant can provide a customized equivalent of a consulting review. Such a consultant can devote the proper amount time needed to accomplish meaningful results—often more than, or sometimes less than, a one-day consultation. Frequently, a consultant is hired on a contract or hourly basis to help CPA firms actually design their quality control systems.

2.400 COMMON DEFICIENCIES FOUND IN ACTUAL PEER REVIEWS

2.401 The most common deficiencies found during actual peer reviews have been supervision-related and are often associated with documentation problems.

*Part I: Supervision-Related Deficiencies:**1. Common workpaper deficiencies:*

- a. Engagement planning was inadequate or was inadequately documented;
- b. Audit program was inadequate or missing; compilation or review engagement program (if required by firm policy) was missing;
- c. Analytical audit or review procedures, audit risk assessment, continued existence, or audit materiality were not considered, were inadequately considered, or were inadequately documented;
- d. Client representation letter was missing or inadequate, or was dated differently than the related auditor's or accountant's report;
- e. Lawyers' letters were missing, inadequate, or not dated reasonably close to the date of the auditor's report;

- f. Confirmations of cash, receivables, or debt, (where appropriate) were inadequate or missing and were not mitigated by appropriate alternative procedures;
- g. Material differences between GAAP depreciation and tax depreciation methods (such as ACRS and MACRS) were not sufficiently evaluated, and related deferred tax liabilities or assets were not appropriately recognized;
- h. Roll-forward procedures were missing or inadequate when inventory was observed or receivables were confirmed at an interim date;
- i. Audit sampling was improperly used or inadequately documented; *and*
- j. Supervisory review of engagement workpapers was inadequate or was not documented.

2. *Common Reporting Deficiencies:*

- a. Auditor's reports lacked a title including the word "independent;"
- b. Accompanying information was not covered in auditor's or accountant's report;
- c. Disclosure about related party transactions was missing or inadequate;
- d. Disclosures about pension plans were missing or inadequate;
- e. Disclosures about leases were missing or inadequate;
- f. Disclosures about current and deferred income taxes were missing or inadequate;
- g. Disclosures about five-year debt maturities were missing;
- h. Debt was improperly classified on the balance sheet;
- i. Disclosure of concentrations of credit risk were missing;
- j. No documentation of any communication about reportable conditions noted in the workpapers concerning internal control structure matters; *and*
- k. Statements of cash flows prepared under the indirect method lacked supplemental disclosures of cash paid for interest and income taxes.

3. *Common Deficiencies on Compilation and Review Engagements:*

- a. Accountant's report did not properly report on all periods presented (including the comparative "current month" column in machine-generated compilations);
- b. Financial statements used inappropriate titles for OCBOA financial statements (cash basis, income tax basis, etc.);

- c. Interim GAAP-basis financial statements omitted income tax provision, depreciation, or interest;
- d. No disclosure was made (either in the notes or the accountant's report) of the basis of OCBOA financial statements and the fact that they are not intended to represent GAAP;
- e. Financial statements did not conform to accounting and/or reporting and disclosure requirements of specialized industries;
- f. Financial statements omitted required disclosures, particularly in the areas of concentrations of credit risk, supplemental cash flows information, related parties, leases, and long-term debt;
- g. GAAP-basis financial statements did not include a cash flows statement for every period for which an income statement was presented;
- h. Accountant's report did not cover supplementary information;
- i. The accountant's compilation report paragraph that describes the omission of substantially all disclosures included inappropriate references to GAAP, "financial position," or "results of operations" when OCBOA financial statements were presented;
- j. Each page of compiled or reviewed financial statements did not include a reference to the accountant's report;
- k. Financial statements did not include or improperly presented deferred income taxes;
- l. Financial statements included improper classification of non-current assets as current or demand notes payable as long-term;
- m. Accountant's report language departed from the guidance contained in *SSARS*, particularly the new language required by *SSARS* No. 7, *and*
- n. Inconsistencies existed between titles reported upon in the accountant's report and those actually used on the financial statements.

Part II: Other Deficiencies:

- 1. Failure to document the firm's compliance with its independence policies and procedures;
- 2. Failure to document the resolution of independence questions;
- 3. Failure to document whether consultation took place when needed;
- 4. Little or no CPE in accounting and auditing areas related to the firm's areas of practice;
- 5. Failure to document the firm's compliance with its client acceptance and continuance policies and procedures; *and*

6. Inadequate or no annual inspection of engagements and of the firm's accounting and auditing policies and procedures.

2.500 SUMMARY

2.501 After you have made a preliminary analysis of your practice and professional requirements, and have set an implementation timetable, you must design and implement your firm's quality control system.

2.502 Gather the policies and procedures that your firm already has, compare them with what your firm needs, and draft additional policies and procedures that will ensure that (1) your firm's quality control system will satisfy professional standards and (2) your firm can document its compliance with its system.

2.503 Once you implement your firm's system, monitor its operation closely at first, using the type of inspection discussed in Chapter 11, and fine tune it as needed.

2.504 It is essential that you provide leadership and involve your staff in the design and implementation process. You should:

1. Explain why the new system is needed;
2. Provide written guidance and an ample supply of quality control materials like checklists and forms;
3. Remember to include your clerical staff in the quality control process;
4. Conduct training sessions (as a bonus, these sessions may qualify for CPE credit); *and*,
5. Request positive feedback and suggestions.

2.600 SAMPLE FORMS AND CHECKLISTS

Workpapers for Design and Implementation

2.601 Your firm must have a quality control system that is tailored to its unique needs and that is in place in a timely manner. The following forms are provided to assist you:

- A checklist to use in assessing the impact of your unique firm factors on the scope of your quality control system (section 2.602),
- A quality control system design and implementation checklist that spells out the steps you must take and the timeframes within which you must complete them (section 2.603),
- A sample memorandum to your staff announcing implementation of your quality control system (section 2.604), *and*
- A sample quality control maintenance timetable in checklist form (section 2.605).

WORKPAPERS FOR DESIGN AND IMPLEMENTATION**Table of Contents**

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Checklist to Determine Scope of Quality Control System

2.602 Your goal in designing your firm's quality control system is to support your practice properly at a cost that is reasonable in terms of both time and dollars. At the same time, it is important not to stifle your firm's future growth by designing a system that is adequate for today but not for changes that you reasonably may anticipate. You should seriously consider implementing a quality control system that will be sufficient for a slightly larger practice than your present one. It is better to grow into your system than to be cramped almost from the start. You may find it helpful to complete the following checklist of firm factors that relate to the scope of quality control systems by answering each question "yes" or "no" in the appropriate box. Although the evaluation is necessarily subjective, each "yes" answer indicates a complicating factor that will increase the need for formality in your firm's quality control system.

2.602

Checklist to Determine Scope of Quality Control System

Prepared by: _____ Date: _____

Reviewed by: _____ Date: _____

INSTRUCTIONS:

This checklist should be completed by the quality control partner. Each "yes" answer indicates a complicating factor that will increase the formality in your quality control system.

	Yes	No
Size of Professional Staff		
1. Does your firm have more than 10 professionals?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate an increase to more than 10 professionals in the near future?	_____	_____
Number of Owners		
1. Does your firm have many partners, as opposed to a sole proprietor or one or two partners?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate a broader-based ownership in the near future?	_____	_____
Number of Offices		
1. Does your firm have more than one office?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate expansion in the near future?	_____	_____
3. Do your satellite operations (or will your anticipated operations) function with relative autonomy?	_____	_____

**CHECKLIST TO DETERMINE SCOPE
OF QUALITY CONTROL SYSTEM**
(Continued)

	Yes	No
Practice Orientation		
1. Is your practice oriented toward accounting and auditing, as opposed to tax or management consulting services?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate a shift towards an accounting and auditing orientation in the near future?	_____	_____
Complexity of Accounting and Auditing Practice		
1. Does your practice include a significant number of audits, as opposed to only a few or none?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate a larger audit practice in the near future?	_____	_____
Type of Accounting and Auditing Clients		
1. Do your firm's accounting and auditing clients include any in specialized or high-risk industries?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate acquisition of any such clients in the near future?	_____	_____
Staff Experience Level		
1. Is your staff relatively inexperienced?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate a less experienced staff in the near future, e.g., because you expect to expand and hire at the entry level?	_____	_____
Staff Monitoring		
1. Is your staff given operating autonomy, instead of being closely monitored?	_____	_____
2. If the answer above is <i>no</i> , do you anticipate a shift away from close monitoring in the near future?	_____	_____

**CHECKLIST TO DETERMINE SCOPE
OF QUALITY CONTROL SYSTEM**
(Continued)

Yes No

Membership in AICPA Division for Firms

- | | | |
|--|-------|-------|
| 1. Does your firm belong to either the PCPS or the SECPS? | _____ | _____ |
| 2. If the answer above is <i>no</i> , do you anticipate membership in the near future? | _____ | _____ |
| 3. If your firm belongs to the PCPS, do you anticipate joining the SECPS in the near future? | _____ | _____ |

Note that if your firm has any SEC clients, it must join the SECPS.

Type of Review

- | | | |
|---|-------|-------|
| 1. Is your firm eligible for an off-site peer review because it does not perform audits? | _____ | _____ |
| 2. If the answer above is <i>no</i> , do you anticipate an audit practice in the near future? | _____ | _____ |

By: _____ Date: _____
(Partner)



Quality Control System Design and Implementation Checklist

2.603 Once you have formed a basic picture of what your firm needs, you are ready to actually design and implement its quality control system. The following checklist summarizes what to do and includes a possible timeframe for completing the steps.

2.603

Quality Control System Design and Implementation Checklist

Prepared by: _____ Date: _____

Reviewed by: _____ Date: _____

INSTRUCTIONS:

This checklist should be completed by the quality control partner. Ideally, the quality control system should be in place 16 months before the review. At a minimum, it should be in place 13 months before the review.

	<u>Initials</u>	<u>Date</u>	<u>Comments</u>
--	-----------------	-------------	-----------------

Follow the steps indicated below to design and implement your quality control system successfully.

1. Gather the necessary information and expertise.

- | | | | |
|--|-------|-------|-------|
| a) Gather all existing written policies and procedures. | _____ | _____ | _____ |
| b) Review relevant professional literature including appropriate AICPA program manuals. | _____ | _____ | _____ |
| c) Consider whether your firm needs to hire additional technical personnel. | _____ | _____ | _____ |
| d) Determine whether a consulting review or hiring of an outside consultant would be beneficial. | _____ | _____ | _____ |
| e) Consider enrolling in appropriate CPE courses. | _____ | _____ | _____ |

2. Evaluate existing policies, procedures, forms, and documents, and determine what new items are needed.

- | | | | |
|--|-------|-------|-------|
| a) Compare existing policies and procedures to minimum documentation requirements and the actual needs of your firm. | _____ | _____ | _____ |
| b) Decide whether new and/or revised policies and procedures are called for. | _____ | _____ | _____ |
| c) Create or acquire new forms and checklists. | _____ | _____ | _____ |
| d) Set responsibilities. | _____ | _____ | _____ |
| e) Create your quality control document. | _____ | _____ | _____ |

**QUALITY CONTROL SYSTEM DESIGN
AND IMPLEMENTATION CHECKLIST**
(Continued)

	Initials	Date	Comments
3. Implement and follow new policies and procedures.	_____	_____	_____
Recommended timeframe for steps 1–3: three months.			
Minimum timeframe for steps 1–3: one month.			
4. Inspect and analyze your results.			
a) Inspect system operation.	_____	_____	_____
b) Compare inspection findings to expected results.	_____	_____	_____
c) Formulate new or revised policies and procedures as necessary.	_____	_____	_____
d) Determine whether further revisions are necessary.	_____	_____	_____
e) Consider whether outside help is needed.	_____	_____	_____
f) Modify policies and procedures as necessary.	_____	_____	_____
Recommended timeframe for step 4: three months.			
Minimum timeframe for step 4: two months.			
5. Finalize your firm's quality control system.			
a) Implement final policies and procedures.	_____	_____	_____
b) Make an interim inspection (optional).	_____	_____	_____
c) Arrange for your firm's peer review.	_____	_____	_____

The authors believe that your firm's quality control system should be in place at least 16 months before its peer review, allowing for the 12-month review period plus a four-month stub period. At a minimum, it should be in place 13 months before your review.

By: _____ Date: _____
(Partner)

**Sample Memorandum to Staff Concerning
Quality Control System**

2.604 Note that this memorandum is appropriate for a firm enrolled in the peer review program. You will have to revise it if you join the Division for CPA Firms.

To: All Firm Members
From: [Name of Managing Partner]
Date:
Subject: Our Firm's Quality Control System

As we have discussed, our firm has demonstrated its commitment to quality by enrolling in the AICPA's Peer Review Program, which is a national program designed to promote quality accounting and auditing work by CPA firms. As part of our enrollment, we are in the process of developing and implementing revisions to our own quality control system. During the next several months you are likely to see changes in the way we do things. Some of these changes will be implemented on an interim, trial-run basis as our final policies and procedures evolve. Please bear with us during this interim period and, by all means, let us know your thoughts, ideas, and suggestions. We are all in this together to build a better and more efficient firm.

[Name of partner or manager] will serve as our Quality Control Partner [or Director of Quality Control] and will be responsible for (1) designing and implementing our new quality control system, including the conduct of CPE sessions to help keep you apprised of our progress, and (2) monitoring the CPE hours of all of our professional personnel.

As specific policies and procedures are developed, they will be summarized in memos to you and, ultimately, they will be included in the firm's Quality Control Manual.

We are excited about these new developments and we believe that we will all be proud of the results. Thank you for helping us in this very important undertaking.

2.605

Quality Control System Maintenance Timetable	
Fiscal Period Beginning: _____	Fiscal Period Ending: _____
Prepared by: _____	Date Completed: _____
Reviewed by: _____	Date Completed: _____

Approximate Date (Based on Calendar Year)		Individual Responsible	Date Completed
1/2	Obtain independence confirmations from all professional firm members.	_____	_____
1/15	Obtain individual CPE confirmations from all professional firm members.	_____	_____
1/15	Conduct client continuation decision process.	_____	_____
4/30	Arrange for and conduct annual inspection (for prior 12/31 Y/E).	_____	_____
6/30	Review and update accounting and auditing library contents.	_____	_____
10/31	Inform all professional firm members of CPE hours reflected to date.	_____	_____
11/30	Make preliminary decisions about next year's:		
	• CPE programs.	_____	_____
	• Hiring needs.	_____	_____
12/15	Make decisions about raises and promotions to be effective 1/1.	_____	_____

2.700 EXHIBITS**AICPA Peer Review Program Questionnaires**

2.701 The AICPA's peer review program and the SECPS Peer Review Program have developed two separate quality control questionnaires, one for sole practitioners with no professional staff (PRP Section 4200) (SECPS PRM section 13.210) and one for firms with two or more professionals (PRP Section 4300) (SECPS PRM section 13.220).

2.702 The PRP forms are reproduced in the exhibits to this chapter. If your firm has an on-site peer review, fill out the appropriate form and provide it to your peer review team captain before the peer review commences. Many small firms use these forms as their quality control document.

2.703

SEC Practice Section*
Peer Review Program

Quality Control Policies and Procedures
Questionnaire for Sole Practitioners With No
Professional Staff

.01 This section of the manual contains a questionnaire that a member of the SECPS must complete prior to the commencement of its review. This questionnaire has been developed for sole practitioners without professional staff. Completion of the questionnaire assists a sole practitioner in accumulating and organizing the information regarding its quality control system.

.02 Sole practitioners should respond directly with "yes," "no," or "N/A" answers and briefly describe, where appropriate, the policies and procedures they have in effect that relate to the questions asked. Where appropriate, sole practitioners should make reference to any firm documents that describe those policies and procedures in more detail. Examples of such documents might be personnel manuals, audit and accounting manuals, a quality control document or manual, and firm forms and checklists. Lengthy and elaborate answers are not expected.

Firm

Prepared By

Date

* This questionnaire is to be used on SECPS peer reviews of sole practitioners with no professional staff only.

SEC Practice Section*
Peer Review Program

**QUALITY CONTROL POLICIES AND PROCEDURES QUESTIONNAIRE
FOR SOLE PRACTITIONERS WITH NO PROFESSIONAL STAFF**

This questionnaire provides the reviewer with basic information. It is not necessarily a checklist of all the policies and procedures that might be applicable to a practice. Sole practitioners who are about to be reviewed should respond directly with "yes," "no," or "N/A" answers and briefly describe, where appropriate, the policies and procedures they have in effect that relate to the questions asked. Where appropriate, make reference to any documents that describe those policies and procedures in more detail. Examples of such documents might be audit and accounting manuals and forms and checklists used in the practice.

Response, Including Reference to Firm Documents

A. Independence

1. Do you adhere to the independence rules, regulations, interpretations, and rulings of the—
 - a. AICPA?
 - b. State CPA society?
 - c. State board of accountancy?
 - d. State accountancy laws?
 - e. SEC and other regulatory agencies?
2. Have you, during the year under review, identified any independence problems with respect to audit or accounting clients?
3. Briefly describe how you do or would resolve independence questions by answering the following—
 - a. What sources do you or would you consult?
 - b. Have you found it necessary to consult with outside parties on independence matters within the last year?
 - c. In what circumstances do you or would you document the resolution of an independence question?

* This questionnaire is to be used on SECPS peer reviews of sole practitioners with no professional staff only.

Response, Including Reference to Firm Documents

4. Do you have any engagements where you act as principal auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement?
5. If the answer to (4) above is "yes"—
 - a. Do you confirm the independence of such other firm(s)?
 - b. Do you do so in writing?
 - c. Do you do so annually?
6. Have you had during the year under review any accounts receivable from clients that may have taken on some of the characteristics of loans and, therefore, may impair your independence?

B. Consultation

1. During the year under review, did you seek consultation from internal or external sources?
2. How do you determine when to consult with outside parties and with whom to consult?
3. Describe the type of information provided to consulted parties to enable them to understand the issue being considered.
4. Describe the extent to which you document consultations with outside parties by answering the following—
 - a. Do you document all such consultations?
 - b. If the answer to (a) is "no", describe the circumstances in which you would document a consultation.
 - c. Does your documentation always, usually, or never include the following information:
 - Description of the issue?
 - The client's position, if any?

Response, Including Reference to Firm Documents

- The possible alternatives?
- The sources consulted (both written materials and people)?
- The information provided to the sources consulted?
- The position indicated by those sources?
- Your conclusion?
- Your underlying rationale?

5. Does your library include current editions of—

- a. AICPA *Professional Standards*?
- b. AICPA industry audit guides relevant to your practice?
- c. FASB pronouncements?
- d. GASB pronouncements, *Government Auditing Standards* (the "yellow book"), and other government audit guides relevant to your practice?

C. Supervision

1. Do you follow documented procedures for planning audit and accounting engagements and, if so, where are those procedures found (for example, in an audit and accounting manual)?
2. If the answer to (1) is "no," briefly describe the procedures you perform in planning audit and accounting engagements in practice, including the information you obtain and consider and when you do your planning. Also describe any variations in those procedures based on factors such as the nature and size of the engagement and prior experience on the engagement.
3. Is a written audit program used on all audit engagements?
4. Do you use written guidance materials regarding the following matters? If so, indicate whether you developed it or obtained it from an outside source, and name the source.

Response, Including Reference to Firm Documents

- a. Consideration of internal control structure in planning and performing an audit.
- b. Assessment of control risk.
- c. Consideration of audit risk and materiality when planning and performing an audit.
- d. Audit sampling techniques.
- e. Degree of reliance placed on analytical procedures.
- f. Form and content of working papers.
- g. Other audit and accounting matters, in the form of an audit and accounting manual.
- 5. Do you use any standardized forms, checklists, or questionnaires? If so, attach a list and describe the types of engagements on which you use them. (Note that the reviewer will want to inspect these forms during the review.)
- 6. Do you use correspondents for audit or accounting engagements? If "yes," describe how (in writing or orally and when this is done) instructions are given to such correspondents and the extent to which you review their work.
- 7. Have you purchased audit or accounting clients from another CPA during the year under review?

D. Professional Development

- 1. Are you in compliance with AICPA and the Section's continuing professional education requirements? If not, indicate how and when you plan to correct the situation.
- 2. Briefly describe how you plan the allocation of your CPE hours among accounting and auditing, tax, and other topics and indicate when that is done.

Response, Including Reference to Firm Documents

3. Do you maintain CPE records and course materials?

E. Acceptance and Continuance of Clients

1. Briefly describe the procedures you follow, including any documents you generally obtain and review and any inquiries you generally make of third parties, before you accept a client for whom you will perform audit or accounting services, in order to provide yourself with reasonable assurance that the client has integrity, to identify any unusual risks that might be associated with the client, and to evaluate your ability to serve the client in a competent and independent manner. Also indicate any variances in those procedures, depending on, for example, the services to be provided.
2. Did you terminate any audit or accounting relationships during the year under review?

F. Inspection

1. Have you performed a timely, formal, documented inspection of your quality control policies and procedures for each year since your last peer or quality review and, if so, have you retained the summary or report for the team captain's review?
2. Have you taken appropriate corrective action in response to the findings on your most recent quality review or peer review?

G. Membership Requirements

1. How do you ensure that you are complying with the section's membership requirements pertaining to—
 - a. Concurring partner review of SEC engagements [membership requirement SECPS §1000.08(f)]?

- b. Refraining from proscribed management advisory services [membership requirement SECPS §1000.08(h)]?
- c. Reporting annually to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client the total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered [membership requirement SECPS §1000.08(i)]?
- d. The firm's statement of philosophy [membership requirement SECPS §1000.08(l)]?
- e. Communicating in writing on a timely basis to an SEC registrant and the Office of the Chief Accountant of the SEC that the client auditor relationship has ceased [membership requirement SECPS §1000.08(m)]?

Response, Including Reference to Firm Documents

[The next page is 13221.]

SEC Practice Section*
Peer Review Program

Quality Control Policies and Procedures
Questionnaire for Firms With Two or More
Professionals

.01 This section of the manual contains a questionnaire that a member of the SECPS must complete prior to the commencement of its review. The questionnaire has been developed for firms with two or more professionals. Completion of the questionnaire assists a firm in accumulating and organizing the information regarding its quality control system.

.02 The reviewed firm should respond directly with "yes," "no," or "N/A" answers and briefly describe, where appropriate, the policies and procedures they have in effect that relate to the questions asked. Where appropriate, firms should make reference to any firm documents that describe those policies and procedures in more detail. Examples of such documents might be personnel manuals, audit and accounting manuals, a quality control document or manual, and firm forms and checklists. Lengthy and elaborate answers are not expected.

Firm

Prepared By

Date

* This questionnaire is to be used on SECPS peer reviews of firms with two or more professionals.

SEC Practice Section*
Peer Review Program

**QUALITY CONTROL POLICIES AND PROCEDURES QUESTIONNAIRE
FOR FIRMS WITH TWO OR MORE PROFESSIONALS**

This questionnaire provides the reviewer with basic information. It is not necessarily a checklist of all the policies and procedures that might be applicable to a firm's practice. Firms about to be reviewed should respond directly with "yes," "no," or "N/A" answers and briefly describe, where appropriate, the policies and procedures they have in effect that relate to the questions asked. Where appropriate, firms should make reference to any firm documents that describe those policies and procedures in more detail. Examples of such documents might be personnel manuals, audit and accounting manuals, a quality control document or manual, and firm forms and checklists.

A. Independence

1. Does the firm, including all its professional personnel, adhere to the independence rules, regulations, interpretations, and rulings of the—
 - a. AICPA?
 - b. State CPA society?
 - c. State board of accountancy?
 - d. State accountancy laws?
 - e. SEC and other regulatory agencies?
2. Describe how the firm informs its professional personnel of the applicable independence requirements (for example, through its personnel manual, audit and accounting manual, training meetings, memoranda).
3. How does the firm inform its professional personnel of the new clients to which independence requirements apply? For example, does the firm—
 - a. Circulate new client lists to all personnel?
 - b. Post new clients on a staff bulletin board?

Response, Including Reference to Firm Documents

* This questionnaire is to be used on SECPS peer reviews of firms with two or more professionals.

Response, Including Reference to Firm Documents

- c. Report new clients at staff meetings?
- d. Use other (describe) means?
- 4. Does the firm obtain at least annually written representations from all professional personnel concerning their compliance with applicable independence requirements? If not, how does the firm monitor compliance with its independence policies? If yes, do these representations affirm that:
 - a. The individual is familiar with the firm's independence policies and procedures?
 - b. Prohibited investments are not held and were not held during the period?
 - c. Prohibited relationships do not exist and that transactions prohibited by firm policy have not occurred?
- 5. Who is responsible for resolving independence questions:
 - a. The engagement partner?
 - b. The managing partner?
 - c. Someone else (identify individual)?
- 6. In connection with the resolution of independence questions—
 - a. In what circumstances must the question and its resolution be documented?
 - b. Where is the documentation maintained (for example, the working paper files or other specific firm or client files)?
 - c. What sources are or would be consulted?
 - d. Has the firm found it necessary within the last year to consult with individuals outside the firm on independence matters?

Response, Including Reference to Firm Documents

7. Does the firm have any engagements where it acts as principal auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement?
 8. If the answer to (7) above is "yes" —
 - a. Does the firm confirm the independence of such other firm(s)?
 - b. Does it do so in writing?
 - c. Does it do so annually?
 9. Does the firm review accounts receivable from clients to ascertain whether any outstanding amounts have taken on some of the characteristics of loans and, therefore, may impair the firm's independence?
 - a. Who does this?
 - b. How often is it done?
 - c. Have there been any such situations during the year under review?
- B. Assigning Personnel to Engagements**
1. Describe the method the firm uses to assign professional personnel to engagements. In that description, include—
 - a. The basis on which assignments are made. For example, some firms make assignments on an engagement by engagement basis; others assign personnel to specific clients and hold them accountable for all services to those clients.
 - b. How staff are advised of their assignments. For example, some firms do this orally; others issue memoranda or copies of scheduling forms; others post assignments to a staff bulletin board.

Response, Including Reference to Firm Documents

- c. Who is responsible for making staff assignments on a day-to-day basis.
 - d. How that person is informed of estimated time requirements and of any special skills or experience that a given assignment might demand.
 - e. How far in advance assignments are typically made.
2. Does the firm require the following to have experience appropriate to the engagement:
- a. Staff?
 - b. Partner-in-charge of the engagement?
 - c. Concurring reviewer?

C. Consultation

1. Have certain areas or specialized situations been identified as requiring consultation? If yes, attach a list of such areas and situations or briefly describe them and indicate where this list will be found (for example, in the quality control document).
2. Does the firm designate individuals as having specialized experience and expertise in certain technical areas and being available for consultation? If yes, attach a list of the individuals designated and what their specialties are and indicate how personnel have been made aware of this information.
3. How are differences of opinion between engagement personnel and specialists resolved?
4. During the year under review, did the firm seek consultation from internal or external sources?
5. How does the firm determine when to consult with outside parties and with whom to consult?

Response, Including Reference to Firm Documents

6. Describe the type of information provided to consulted parties to enable them to understand the issue being considered.
7. Describe the extent to which the firm expects consultations to be documented. Where is such documentation maintained?
8. Does the firm's library include current editions of—
 - a. AICPA *Professional Standards*?
 - b. AICPA industry audit guides relevant to the firm's practice?
 - c. FASB pronouncements?
 - d. GASB pronouncements, *Government Auditing Standards* (the "yellow book") and other government audit guides relevant to the firm's practice?
9. Has the firm issued guidance to its professional personnel regarding reports on the application of accounting principles as described in SAS 50? If yes, attach a copy of that guidance. Also, indicate whether the firm issued any such reports during the year under review.

D. Supervision

1. Does the firm follow documented procedures for planning audit and accounting engagements and, if so, where are those procedures found (e.g., in an audit and accounting manual)?
2. If the answer to (1) is "no," briefly describe the procedures the firm performs in planning audit and accounting engagements in practice, including the information obtained and considered and the nature, timing and extent of partner involvement in the planning process. Also describe any variations in those procedures based on factors such as the nature and size of the engagement and prior experience on the engagement.

3. Is a written audit program used on all audit engagements? If yes, who is required to review and approve the audit program, and how is this approval documented?
4. Indicate whether the firm has written guidance materials regarding the following matters. If so, indicate where the material is found and whether it was developed internally or was obtained from an outside source, and name the source.
 - a. Consideration of internal control structure in planning and performing an audit.
 - b. Assessment of control risk.
 - c. Consideration of audit risk and materiality when planning and performing an audit.
 - d. Audit sampling techniques.
 - e. Degree of reliance placed on analytical review procedures.
 - f. Form and content of working papers.
 - g. Other audit and accounting matters, in the form of an audit and accounting manual.
5. Does the firm use any standardized forms, checklists, or questionnaires? If so, attach a list and indicate whether the use of each is required or discretionary. (Note that the reviewer will want to inspect these forms during the review.)
6. Has the firm established procedures to be followed when differences of opinion exist among firm personnel on an audit (see AICPA *Professional Standards*, AU section 311.14)?
 - a. Are those procedures documented?
Where?

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Response, Including Reference to Firm Documents

- b. Do those procedures allow an assistant to document his or her disagreement with the conclusion reached?
- 7. Does the firm use other offices or correspondents for audit or accounting engagements? If "yes," describe the form in which instructions are given to other offices or correspondents and the extent to which their work is reviewed, or indicate where the firm's procedures for the supervision and control of that work are found.
- 8. Does the firm have documented procedures for review by supervisors and partners of the reports, financial statements, and working papers for—
 - a. Audits?
 - b. Reviews?
 - c. Compilations?
- 9. If the answer to (8) is "yes," indicate where those procedures are found. If the answer is "no," briefly describe the procedures that are followed, including how the review process is documented.
- 10. Does the firm require that an individual having no other significant responsibility for the engagement perform a preissuance review of some or all engagements? If "yes," indicate who performs such preissuance reviews and briefly describe the extent of the review and how the review is documented, indicating the types of engagements to which the procedures are applicable. Alternatively, indicate where these procedures are found.
- 11. Has the firm merged with any other firm since the date of its last peer or quality review or in the last three years? If "yes"—
 - a. Did the firm acquire any professional personnel in the merger?

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- b. Did the firm acquire and retain any new office or offices in the merger (indicate the locations of any such offices)?
 - c. Have the personnel of the merged firm adopted the firm's quality control policies and procedures?
12. How does the firm evaluate the quality of a potential merger candidate?

E. Hiring

- 1. Briefly describe how the firm identifies its professional personnel needs, how it goes about recruiting such personnel, and who makes the decision to hire an applicant.
- 2. Briefly describe the personal, educational, and experience attributes sought in entry-level personnel and in experienced personnel and indicate whether they are objectives or requirements.
- 3. Identify the types of background information the firm requires for new hires, such as resumes, transcripts, and personal or employment references.
- 4. Briefly describe how new professional personnel are informed about the policies and procedures that are applicable to them. Also, attach a list of the manuals, professional publications, and other documents relevant to their professional assignments that are provided to them individually.

F. Professional Development

- 1. Are all professional personnel in compliance with AICPA and the Section's continuing professional education requirements? If not, attach an analysis by level and discipline (e.g., audit, tax, consulting) of personnel who are not in compliance and indicate the firm's plan for correcting the situation.

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2. Briefly describe how the firm plans the allocation of CPE hours among accounting and auditing, tax, and other topics and indicate when that is done.
3. Provide an approximation of the nature of the CPE taken by professional personnel assigned to audit and accounting engagements:
 - a. Self-study courses ____%
 - b. In-house training programs—
 - (i) Developed by the firm ____%
 - (ii) Obtained from outside vendors .. ____%
 - c. State society or AICPA programs ____%
 - d. Other programs ____%
4. Who maintains CPE records and course materials?
5. How is compliance with the Section's and other applicable (e.g., state, AICPA, governmental) CPE requirements monitored?
6. How are professional personnel made aware of changes in accounting and auditing standards and in the firm's technical policies and procedures (for example, by distributing technical pronouncements and holding training courses on recent changes and areas noted by the firm as needing improvement)?

G. Advancement

1. What levels of responsibility exist within the firm (e.g., partner, manager, senior)?
2. Are personnel at all levels aware of the responsibilities of each of these positions? How is this accomplished? Are those responsibilities documented in, for example, a personnel manual?
3. Does the firm periodically evaluate the performance of professional personnel and advise them of their progress in the firm?

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- a. When are these evaluations performed?
- b. Are they documented?
- c. Is a standard evaluation form used?
- 4. Are partners periodically evaluated, and by what means (e.g., peer evaluation, self-appraisal, counseling)?
- 5. Briefly describe how advancement decisions are made (a) within the professional staff and (b) to the partnership.

H. Acceptance and Continuance of Clients

- 1. Briefly describe the procedures followed by the firm, including any documents generally obtained and reviewed and any inquiries generally made of third parties, before accepting a client for whom the firm will provide audit or accounting services in order to provide the firm with reasonable assurance that the client has integrity, to identify any unusual risks that might be associated with the client, and to evaluate the firm's ability to serve the client in a competent and independent manner. Also indicate any variances in those procedures, depending on, for example, the services to be provided.
- 2. Indicate when or under what circumstances current audit and accounting clients are evaluated to determine whether the relationship should be continued, and briefly describe the procedures that are followed.
- 3. Were any audit or accounting client relationships terminated by the firm during the year under review?

I. Inspection

- 1. Does the firm perform timely annual inspections? If "yes," briefly describe—

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- a. The scope of the program, including who carries it out.
 - b. The materials used, such as questionnaires, programs, and checklists.
 - c. The documentation of the work performed and conclusions reached and the period of time such documentation and conclusions are retained.
2. Has the firm taken appropriate corrective action in response to the findings on its most recent quality review or peer review?

J. Membership Requirements

1. How does the firm ensure that it is complying with the section's membership requirements pertaining to —
- a. Partner rotation on SEC engagements [membership requirements SECPS §1000.08(e)]?
 - b. Concurring partner review of SEC engagements [membership requirement SECPS §1000.08(f)]?
 - c. Refraining from proscribed management advisory services [membership requirement SECPS §1000.08(h)]?
 - d. Reporting annually to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client the total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered [membership requirement SECPS §1000.08(i)]?
 - e. Communicating the firm's statement of philosophy [membership requirement SECPS §1000.08(l)]?

- f. Communicating in writing on a timely basis to an SEC registrant and the Office of the Chief Accountant of the SEC that the client auditor relationship has ceased [membership requirement SECPS §1000.08(m)]?

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INDEPENDENCE
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CHAPTER 3

INDEPENDENCE

3.000 WHAT "INDEPENDENCE" MEANS

3.001 Inherent in any quality control system is the underlying philosophy that your firm will closely adhere to, and monitor its compliance with, the pervasive professional requirements—including American Institute of Certified Public Accountants (AICPA) and state accountancy board independence rules.

3.002 For audits and reviews, you must be independent in appearance as well as in fact. If you are not independent, you may not issue an audit or review report. For a compilation, you must state in your report that you are not independent.

3.003 Regardless of how small your practice may be, you must establish policies and procedures to provide reasonable assurance that all persons in your firm are, at all levels, aware of and maintain independence in fact and in appearance.

3.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

3.101 SQCS No. 1. Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to independence:

Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 [ET section 101.01] of the rules of conduct contains examples of instances wherein a firm's independence will be considered to be impaired.

Note: Although SQCS No. 1 was issued in 1979, some firms are not yet in compliance with its documentation requirements related to independence.

3.102 Code of Professional Conduct. The AICPA's Code of Professional Conduct, ET section 55 ("Objectivity and Independence"), reads in part as follows:

A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

3.103 ET section 101 ("Interpretations under Rule 101—Independence") interprets situations in which independence might be considered impaired, including the following:

Independence shall be considered to be impaired if, for example, a member had any of the following transactions, interests, or relationships:

- A. During the period of a professional engagement or at the time of expressing an opinion, a member or a member's firm:
 - 1. Had or was committed to acquire any direct or indirect material financial interest in the enterprise.
 - 2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the enterprise.
 - 3. Had any joint, closely held business investment with the enterprise or with any officer, director, or principal stockholders thereof that was material in relation to the member's net worth or to the net worth of the member's firm.
 - 4. Had any loan to or from the enterprise or any officer, director, or principal stockholder of the enterprise except as specifically permitted in Interpretation 101-5.
- B. During the period covered by the financial statements, during the period of the professional engagement, or at the time of expressing an opinion, a member or a member's firm:
 - 1. Was connected with the enterprise as a promoter, underwriter, or voting trustee, as a director or officer, or in any capacity equivalent to that of a member of management or of an employee.
 - 2. Was a trustee for any pension or profit-sharing trust of the enterprise.

The above examples are not intended to be all-inclusive.

Practice Tip:

All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55 that appear at ET section 101, and the related individual rulings that appear at ET section 191 ("Ethics Rulings on Independence, Integrity and Objectivity").

State Boards of Accountancy and Societies

3.104 The individual state boards of accountancy and societies have adopted the AICPA independence rules and many jointly participate with the AICPA in enforcing them.

Other Regulatory Agencies

3.105 If your firm practices before other regulatory agencies, such as the SEC or HUD, you should be aware of, and comply with, any specific independence requirements that those agencies impose.

3.200 HOW TO ADDRESS INDEPENDENCE

3.201 Your firm needs to develop basic policies and procedures to ensure (and document) that it and all professional firm members are independent of its financial statement clients (or, if for any reason the firm is *not* independent, that the firm is fully aware of its lack of independence and that only a compilation report is issued, with the lack of independence noted therein).

Basic Approach

3.202 Your firm may use *four* approaches (or a combination of them) to satisfy the quality control requirements as they pertain to independence:

1. Obtain annual written representations from firm personnel,
2. Consider during individual engagement planning,
3. Perform new client preacceptance reviews, *and*
4. Obtain confirmations from other auditors.

The details of the four approaches are explained below. (See section 3.502 for some examples of AICPA rulings on independence situations.)

3.203 Obtain Annual Representations from Firm Personnel. On *at least an annual basis* you should have each partner, principal, and professional staff member execute, and return to the firm, an independence representation (see the sample Independence Representation in section 3.602). New firm members should do so when they join the firm.

Practice Tip:

As mentioned in section 2.120, one firm member (that is, the managing partner, quality control partner, or proprietor) should be responsible for obtaining the confirmations, making sure everyone knows and *understands* the requirements, and resolving independence questions.

The best practice is to obtain the confirmations as of the *same date* each year—for example, as of the first day of the firm's fiscal year.

Another good idea, although not specifically required, is to have each member of your *administrative* staff also complete a representation. Some past SEC actions have resulted from nefarious activities by wordprocessors, office managers, proofreaders, and the like.

You should also train your staff to be constantly alert to possible independence conflict situations and to bring them to the attention of the appropriate person at the earliest possible moment.

3.204 Consider During Individual Engagement Planning. During the planning process for *each* individual financial statement engagement (particularly audits), your engagement staff should (1) address independence—including past-due fees (see section 3.310)—as a separate and distinct issue and (2) *document* the firm's independence. Preferably, your documentation should appear in the engagement planning memorandum (see Chapter 5), which is contained in the planning and administration section of the workpapers.

3.205 Perform New Client Preacceptance Reviews. Independence should be one of the primary factors you consider (and document) *before* deciding to accept new clients—particularly if you will report on the financial statements (see Chapter 7).

3.206 Obtain Confirmations From Other Auditors. When your firm acts as principal auditor and another firm is engaged to perform a segment of the engagement (for example, to observe an inventory in a distant location or to audit a subsidiary), you should confirm the independence of the other firm at least annually (see the Request for Independence Representation From Another Auditor in section 3.604).

Resolution of Independence Questions

3.207 If your firm notes any *possible* independence questions after following the procedures discussed above, you should *thoroughly* research, address, and document the problem *before* you begin work on the engagement (see Chapter 4, section 4.303 for a further discussion of research and Chapter 3, section 3.603 for the Independence Query and Resolution Documentation Form for an example of how to address and document the problem). Discovering toward the end of an extensive engagement that the firm is not independent with regard to the client might prove extremely embarrassing and costly. You will probably find it difficult to collect your fees for the time spent. Another independent CPA firm will probably have to repeat much of the same work and the client will probably, to say the least, be extremely upset.

Sources of Answers

3.208 You can find the answers to most independence questions in the rulings contained in the "AICPA Code of Professional Conduct," ET section 191 (AICPA *Professional Standards*, Vol. 2). In the rare instances when ET section 191 does not answer your question, your firm should telephone the Ethics Division of the AICPA at (201) 938-3187.

3.300 SOME TIPS AND TECHNIQUES

Document Properly

3.301 Unfortunately, many local firms have not yet documented compliance with the independence element to the extent necessary to satisfy peer review requirements.

3.302 Actual peer reviews have demonstrated the following documentation problems with regard to independence:

1. Failure to document the firm's compliance with its independence policies and procedures, *and*
2. Failure to document the resolution of independence questions.

Practice Tip:

The authors believe your firm should *specifically* implement all four approaches discussed in section 3.202, if it has not already done so. It should obtain the annual independence confirmations (see section 3.203), consider independence during the individual engagement planning process (see section 3.204), expand its new client investigative procedures (see section 3.205), and confirm independence of any other auditors involved (see section 3.206).

Relatives

3.303 Independence sometimes might prove to be a difficult area for a local firm—which may have built its client base from work generated by relatives.

3.304 Your independence may be impaired if you are engaged to perform services for a company that a relative owns or for which a relative works. Your independence on such an engagement depends on how close the family relationship is and what their position is. According to the Code of Professional Conduct, you should not participate in an engagement if a spouse or a dependent person is in a position of "significant influence" over the client's operating, financial, or accounting policies (ET section 101.11).

3.305 Additionally, if a "nondependent close relative" works in a position of "significant influence," or if that person's activities are "audit sensitive," your independence also is impaired and you should not

accept the engagement. According to the Code of Professional Conduct, close relatives are nondependent children, stepchildren, brothers, sisters, grandparents, parents, parents-in-law, and their respective spouses (ET section 101.11).

Investments With Clients

3.306 The Code of Professional Conduct prohibits a CPA from having or committing to acquire "any direct or material indirect financial interest" in a professional engagement or from holding "any joint, closely held business investment with the enterprise or with any officer, director, or principal stockholders thereof" (ET section 101.02).

3.307 The prohibition against any *direct* interests means that you are barred from owning, for example, so much as a *single* share—even if the ownership is totally immaterial to both you and your client.

3.308 The meaning of the prohibition against *joint, closely held business investments* depends heavily upon the nature of the relationship between you and the enterprise whose financial statements are being issued. Key factors include the materiality of the investment with regard to your individual net worth or that of your firm, and how widely held the investment is. Even joint investments in a vacation home may be considered to be "joint, closely held business investments".

3.309 Interpretations of the Code of Professional Conduct (ET section 101.10) and the Ethics Rulings (ET Section 191) provide guidance on independence and financial interests with clients.

Accounts Receivable

3.310 In an attempt to maintain good relationships with their clients, some local practitioners are often less aggressive than they might be about collecting outstanding fees. Both the AICPA and SEC take the position that an outstanding fee, due for one year, becomes a *loan* and therefore affects the firm's independence with regard to the *following year*. Accordingly, if a financial statement client still owes you fees related to an engagement when you begin to do the planning work for the *following year*, your unpaid bill poses an independence problem.

3.311 Specifically, the AICPA has ruled that your independence is impaired unless fees for all professional services rendered for prior years are collected before you issue your report on the financial statements for the current year (ET sections 191.103–.104). According to the SEC's even more restrictive interpretation, you should not even begin the planning process until the prior year's fees are collected.

Practice Tip:

You might use this independence problem as a tool to help prod the client into payment. Your firm might also want to adopt the more restrictive SEC rules for its practice *in general*. The SEC rule makes more sense from a practice management point of view. After all, you are an accountant—not a banker.

Staff Members Obtained Through Clients

3.312 CPA firms sometimes locate their professional staff members through recommendations from clients. If a firm member engaged in this way is a *client's relative*, you should consider the impact that the relationship between the firm member and the client has on your firm's independence (see section 3.304).

3.313 Larger firms might actually have a slight advantage over sole practitioners and extremely small firms with regard to independence—because they might be able to complete an engagement for which an individual nonmanagerial *staff member* of the firm lacks independence merely by *excluding* that individual from work on the engagement. However, the firm would have to research and *monitor* this solution carefully.

Be Careful With Tax Clients

3.314 A CPA firm will often begin its association with a client by doing tax work. It is O.K. to undertake tax engagements in which you are not independent. However, a problem arises if and when that client asks you to expand the level of your work to include reporting on the financial statements.

3.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE INDEPENDENCE ELEMENT

3.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire: (See section 2.700 in Chapter 2)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Requires all professional personnel to adhere to applicable independence rules, regulations, interpretations, and rulings?
- Communicates its policies and procedures relating to independence to all professional personnel?
- Requires, when acting as principal auditor, confirmation of the independence of another firm engaged to perform segments of an engagement?
- Adequately monitors compliance with its policies and procedures relating to independence on a timely basis?
- Complied with its independence policies and procedures during the period and adequately documented its compliance to the extent required by firm policy?

3.500 SAMPLE POLICIES AND PROCEDURES

3.501 With regard to the independence element, *all* firms, regardless of their size, need to adopt the *theories* behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. The AICPA sample appears below. Alternative, simpler wording for smaller firms is provided in sections 3.503–.505.

AICPA Sample System

3.502 The AICPA's suggested sample policies (in *italics*) and procedures on independence read as follows:

1. *Require that personnel at all organizational levels adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, state CPA society, state board of accountancy, state statute, and, if applicable, the Securities and Exchange Commission and other regulatory agencies.*
 - a. Designate an individual or group to provide guidance and to resolve questions on independence matters.
 - (i) Identify circumstances where documentation of the resolution of questions would be appropriate.
 - (ii) Require consultation with authoritative sources when considered necessary.
2. *Communicate policies and procedures relating to independence to personnel at all organization levels.*
 - a. Inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures.
 - b. Emphasize independence of mental attitude in training programs and in supervision and review of engagements.
 - c. Apprise personnel on a timely basis of those entities to which independence policies apply.
 - (i) Prepare and maintain for independence purposes a list of the firm's clients and of other entities (client's affiliates, parents, associates, and so forth) to which independence policies apply.
 - (ii) Make the list available to personnel (including personnel new to the firm or to an office) who need it to determine their independence.
 - (iii) Establish procedures to notify personnel of changes in the list.
 - d. Maintain a library or other facility containing professional, regulatory, and firm literature relating to independence matters.

3. *Confirm, when acting as principal auditor, the independence of another firm engaged to perform segments of an engagement.*
- a. Inform personnel about the form and content of an independence representation that is to be obtained from a firm that has been engaged to perform segments of an engagement.
 - b. Advise personnel about the frequency with which a representation should be obtained from an affiliate or associate firm for a repeat engagement.
4. *Monitor compliance with policies and procedures relating to independence.*
- a. Obtain from personnel periodic, written representations, normally on an annual basis, stating that—
 - (i) They are familiar with the firm's independence policies and procedures.
 - (ii) Prohibited investments are not held and were not held during the period. As an alternative or additional procedure, a firm may obtain listings of investments and securities transactions (numbers of shares or dollar amounts need not be included) from personnel to determine that there are no prohibited holdings.
 - (iii) Prohibited relationships do not exist, and transactions prohibited by firm policy have not occurred.
 - b. Assign responsibility for resolving exceptions to a person or group with appropriate authority.
 - c. Assign responsibility for obtaining representations and reviewing independence compliance files for completeness to a person or group with appropriate authority.
 - d. Review periodically accounts receivable from clients to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

Alternative Sample System

3.503 The following alternative sample system (in *italics*) and procedures are alternatives to the AICPA language. You should use it as a guide, adapting it to meet your own special needs.

3.504 *It is our firm's policy that all of its personnel adhere to the independence requirements of the AICPA and our state CPA society and board of accountancy (and the SEC).*

3.505 *The procedures listed below are to be followed with regard to this policy:*

1. Personnel are required to execute representations, when hired and annually thereafter, acknowledging knowledge of and compliance with independence requirements.
2. Personnel are required to notify the firm, through the managing partner (or quality control partner or proprietor), of any potential independence questions of which they become aware.
3. Engagement personnel are required to consider and document independence toward the beginning of the planning phase of each financial statement engagement.
4. The partner in charge of each financial statement engagement is required to monitor and consider significant unpaid fees that would impair our firm's independence.
5. When our firm acts as principal auditor and another firm is engaged to examine a component, or to perform procedures (such as inventory observations), engagement personnel are required to obtain a written representation at least annually from the other firm regarding its independence.
6. The managing partner (or quality control partner or proprietor) is responsible for obtaining independence representations (see 1. above) and for resolving independence questions (see 2 above). When necessary, he/she should consult with the AICPA for assistance. Documentation of resolution of independence questions should be placed in the client's workpaper files.

3.600 SAMPLE DOCUMENTATION

3.601 Your documentation must show that your firm monitors compliance with its independence policies and procedures at least annually. You can provide this evidence by:

1. Annual written representations from your firm members (section 3.602),
2. Consideration of independence in each engagement planning memorandum (section 5.607 of Chapter 5),
3. Memoranda of inquiry about independence questions and their resolution (section 3.603);
and
4. Written representations from other auditors, if any (section 3.604).

3.602 Annual Independence Representation

1. I have read, and understand, the independence requirements of the AICPA and our State Board of Accountancy and CPA Society (and the SEC).
2. I have read the firm's financial statement client listing, dated _____ .
3. To the best of my knowledge and belief, I am in compliance with applicable independence requirements with regard to all clients on the list referred to in Item 2 above, except as noted below under "Possible Independence Questions."

Possible Independence Questions

List each client with which you have a possible independence question. Complete and attach an Independence Query and Resolution Documentation Form for each. Attach additional sheets if necessary.

- 1.
- 2.
- 3.
- 4.

Date: _____

Signature: _____

Print Name: _____

**3.603 Independence Query and Resolution Documentation Form**

Part 1: Query (to be completed by originator)

1. Client or potential client:
2. Possible independence question:

Date: _____

Signature: _____

Print Name: _____

Part 2: Resolution (to be completed by managing partner, quality control partner, or proprietor)

1. Authoritative sources referred to (attach copies):
2. Conclusion (and reasons therefor):

Date: _____

Signature: _____

Print Name: _____

Return one copy of completed form to the originator, place one copy in the client's workpaper file, and keep one copy on file with all independence-related documents.

3.604 Request for Independence Representation From Another Auditor*(To be typed on your firm's letterhead)*

[Date] _____

[Other auditing firm's name and address]

Re: [Name of client] _____

Dear Managing Partner:

As you are aware, we have been engaged by the above referenced client to audit its financial statements for the year ended _____, and you have been engaged, in conjunction therewith, to _____

[description of the work to be performed by the other auditor].

In connection with our audit, please furnish us, in writing, with the following representation:

We are familiar with the independence requirements of the American Institute of Certified Public Accountants, and we are independent with regard to _____ [names of your client and entity the other firm is auditing] under those requirements.

Very truly yours,

[Signature] _____

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CONSULTATION

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CHAPTER 4

CONSULTATION

4.000 WHAT "CONSULTATION" MEANS

4.001 Consultation, as the term is used here, does not refer to the consulting services that you provide to your clients, but refers instead to the assistance you should request from *others* — because your knowledge and experience in a particular area are limited. In such instances, you must seek guidance from authoritative sources, such as appropriate professional literature or fellow professionals who might be more knowledgeable about a particular subject than you are.

4.002 Your consultation policies and procedures must reasonably ensure that you and your staff will seek assistance, to the extent required, from persons having the required knowledge, competence, judgment, and authority under the circumstances.

4.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

4.101 SQCS No. 1. Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to consultation:

Policies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation will depend on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

Note: Although SQCS No. 1 was issued in 1979, some firms are not yet in compliance with its documentation requirements related to consultation.

4.102 Code of Professional Conduct. The AICPA Code of Professional Conduct, ET section 56, "Due Care," reads as follows:

A member should observe the profession's technical and ethical standards, *strive continually to improve competence* and the quality of services, and discharge professional responsibility to the best of the member's ability. [Emphasis added.]

Compliance with the consultation element is one way to meet the Code's competence requirement.

4.200 HOW TO ADDRESS CONSULTATION

4.201 Your firm needs to develop and comply with some basic policies and procedures to ensure (and document) that its professional firm members are aware of how, when, with whom, and about what they should consult when they run into an accounting or auditing situation that is beyond their level of knowledge or experience.

Practice Tip:

Staff members must understand that it *benefits the firm* (and is not a sign of weakness) for them to use the knowledge and experience of others in helping to solve the various accounting and auditing problems that they encounter. Everyone involved in the process should view use of all available resources as a *learning experience*.

Basic Approach

4.202 To satisfy the quality control requirements as they pertain to consultation, you must train your engagement personnel to know:

1. *When* and *about what* to ask,
2. *Whom* to ask,
3. *How* to ask (and how to do their own initial research),
4. How to *document* the decisions that are reached.

Select and List "Firm Consultants"

4.203 Most local firms already have well-developed internal consultation practices that they follow on an informal (undocumented) basis, and have individuals at upper levels who are recognized as more knowledgeable about certain accounting and auditing matters. Professional staff members ordinarily will consult, informally, with a knowledgeable individual when they encounter a problem in that individual's area of expertise.

4.204 Your firm should officially recognize these unique areas of knowledge and designate knowledgeable individuals as official "firm consultants." You should develop and maintain a list of the official consultants and their particular areas of expertise (see section 4.603 for a sample list). You should *require* engagement personnel to take each problem they encounter to the consultant who is knowledgeable in the particular area for the consultant's advice or resolution.

Practice Tip:

Your list need not be a long one and need only concern accounting and auditing (financial statement) matters. It should, however, specifically cover newly issued and complex accounting and auditing requirements — particularly as they pertain to your firm's particular practice.

4.205 If, on the other hand, you truly believe, after due consideration, that you are all generalists and your firm has no "consultants," you should document that decision. In that case, you may decide to identify some *outside* consultants.

Document Compliance

4.206 As previously discussed, in many local firms, a consultation may occur or research may be done, but the staff fails to take the necessary extra step of documenting it. When a consultation occurs, or your engagement personnel seek the advice of the "consultant," *documentation* should be completed and placed into the appropriate workpaper file, along with all related backup (see section 4.604 for a sample form).

Allow Dissenting Opinions

4.207 Because a CPA firm must maintain its *objectivity*, independence, and sense of professional skepticism, it *must* recognize dissenting opinions in consultation situations. Accordingly, you *must* give a partner, principal, or professional staff member who is party to the consultation, and who ultimately disagrees with the decision reached, the opportunity to document his or her point of view and the reasoning behind it in the workpapers.

Sources of Information

4.208 Your firm must maintain, or have easy access to, a *current* accounting and auditing library that applies to the services it provides. However, your consulting reference sources should not be limited to those within the firm. You can, and should, use the numerous consultation sources available *outside* the firm. Minimal library contents and some of the outside sources are explained below.

Your Library

4.209 Actual peer reviews have shown that lack of access to an adequate, up-to-date accounting and auditing library is one of the primary consultation problem areas. Every firm that issues financial statements should, at a minimum, own or have easy access to the American Institute of Certified Public Accountants (AICPA) publications listed in exhibits 1-3 in sections 4.608–4.610 of this chapter.

Practice Tip:

The "Technical Information Service Inquiries and Replies" section of the *AICPA Technical Practice Aids* is particularly helpful because it contains selected practice problems that the staff of the AICPA's Technical Information Division has already answered. The section's inquiry/reply format makes it an easy to use source for research and straightforward answers.

AICPA

4.210 The AICPA offers several consultation services that you can use to supplement your own library and when you need additional advice on accounting and auditing problems.

4.211 You may call a toll-free number for an oral response from the Technical Information Division Hotline: 800-TO-AICPA (800-862-4272).

4.212 The AICPA also maintains the National Automated Accounting and Retrieval Service (NAARS), a computer-based research system that will allow you direct access to an extensive database for research purposes, particularly on financial statement presentation matters. The AICPA will, for a fee, do your research for you in response to your telephone inquiry. You can also arrange for your own computer link with the database. For information about NAARS, call the AICPA at (201) 938-3248.

4.213 In addition, many AICPA publications are now available in electronic format, and are accessible with just a few keystrokes on your computer. These electronic products are available through updated quarterly subscriptions or in an annual edition.

State Societies

4.214 Most state societies maintain consultation committees and publish the names and telephone numbers of members who are available to assist their fellow practitioners on individual practice problems.

Your Fellow Professionals

4.215 You should feel free to consult with other practitioners in your own city, your own office building, and so forth who you believe possess the knowledge on a particular subject that you need in a specific situation. Many local offices of national firms also provide this service to local firms.

Consultants

4.216 A new type of firm has developed in the profession — staffed by technical "gurus" and dedicated primarily to providing consultation, concurring review, and quality control services to small- to medium-sized firms.

4.300 SOME TIPS AND TECHNIQUES

Document Properly

4.301 Engagement personnel, as well as partners and reviewers, need to make sure that each individual file contains documentation of all research and consultations. Documentation should consist of a memorandum stating the reasons for the consultation, the sources consulted, and the conclusions reached. The memorandum should be in a form that is clear, concise, neat, and easy to follow. It should also contain *all* of the relevant facts (even if some of those facts may lead to a conclusion the client may not like). Copies of professional pronouncements to which a memorandum refers should also be attached, with appropriate sections highlighted. A sample form is included in section 4.604 of this chapter.

Research Properly

4.302 You also should maintain your independence, objectivity, and sense of professional skepticism, when doing research. *Never* force an answer based on what a client wants. Let your research lead you to your own natural conclusion.

Illustration

4.303 Assume you have a question about the form and content of disclosures concerning life insurance that a small business client carries on an officer so that it can redeem the officer's stock after his or her death. The shareholders would prefer *not* to make any disclosure about this.

4.304 As you undoubtedly know from your experience with accounting and auditing research, your first step is to identify the key words or phrases you will research. In this case, the key phrases are "life insurance," "contingent liabilities," and "stock repurchase agreements."

4.305 When you turn to the table of contents of the *AICPA Technical Practice Aids*, you find the following areas that might relate to these key words:

- Section 2240 — Cash Surrender Value of Life Insurance
- Section 3400 — Contingent Liabilities
- Section 4120 — Reacquisition of Capital Stock
- Section 4140 — Stock Options and Stock Repurchase Plans

4.306 After reading those four sections, you decide that the last two really do not address your problem. However, you may find the first two, sections 2240 and 3400, are relevant; they are also similar. The second, which is much less detailed, reads as follows:

3400.02 Disclosure of Agreement Between Corporation and Its Shareholders

Inquiry — Corporation A, a closely held entity, has an agreement with its shareholders under which Corporation A could become obligated to purchase a certain number of shares of stock of deceased shareholders at book value. Should Corporation A disclose this agreement in its financial statements?

Reply — Corporation A should disclose the terms of the agreement in a note to its financial statements since it is a contingent liability.

4.307 When you read Reply 2240.02 in Section 2240, you realize that you have found the answer to your question — which is that the redemption plan *must* be disclosed:

2240.02 Disclosure of Life Insurance on Principal Stockholders

Inquiry — A client corporation maintains life insurance policies on its principal stockholders which will provide for the repurchase of the stock in the event of a stockholder's death. The cash surrender value of these policies appears on the balance sheet. Is further disclosure necessary?

Reply — The rule of informative disclosure requires that the essential facts regarding firm commitments for purchase of a corporation's own stock pursuant to a buy-sell agreement, be set forth in a note to the financial statements.

Below is an example of a note describing such a situation which might appear on the balance sheet in reference to the cash surrender value account:

The company is the owner and beneficiary of key-man life insurance policies carried on the lives of X, Y, and Z bearing face value amounts of \$500,000, \$500,000 and \$450,000, respectively. No loans are outstanding against the policies, but there is no restriction in the policies regarding loans.

The life insurance contracts are accompanied by mandatory stock purchase agreements to the amount of the proceeds of the life insurance. In the event of the insured's death, the "fair market value" of the stock will, by previous action, be established by the X Appraisal Company. The insured's estate will be obligated to sell, and the company will be obligated to purchase the insured's stock up to the appraisal value of the stock or the proceeds of insurance, whichever is the lesser. The purpose is to protect the company against an abrupt change in ownership or management.

Review Thoroughly

4.308 The partner or reviewer on the engagement must ensure that necessary research is conducted, that required consultation practices are followed (that is, that consultations are sought when appropriate and are adequately documented in the files), and that the related statements or workpapers reflect your follow-through on the conclusions. (See section 4.203 for one way to accomplish this.)

Control Outside Consultations

4.309 One person (such as the managing partner, quality control partner, or proprietor) should probably control all out-of-house consultations, including those with the AICPA. Such centralization gives the person in charge the opportunity to identify the appropriate consultation and to make sure the consultant has *all* of the relevant facts. It also spares your firm the waste of time and money, and the embarrassment associated with asking the same question more than once and with asking needless questions.

Assign Responsibility for Your Library

4.310 Someone within your firm (such as the managing partner, quality control partner, or proprietor) should be responsible for maintaining (or ensuring access to) an adequate accounting and auditing reference library and making sure it is updated on a timely basis. If this responsibility is not assigned to, and accepted by, someone, your library will quickly be out of date and you will receive a negative comment on your peer review. (See the exhibits in sections 4.608–4.610 of this chapter for the suggested minimum library contents.)

Distribute Newly Issued Technical Pronouncements

4.311 Someone within your firm (normally the same person who is responsible for keeping the library up to date) should also be responsible for making sure that all appropriate newly issued technical pronouncements of the AICPA, Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board (GASB), the Securities and Exchange Commission (SEC), and the like are distributed to firm members.

4.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE CONSULTATION ELEMENT

4.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire: (See section 2.700 in chapter 2.)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Appropriately identifies areas and specialized situations where consultation is required?
- Designates, if applicable, appropriate individuals as specialists to serve as authoritative sources?
- Specifies the authority to be accorded specialists in consultations?
- Provides adequate procedures for resolving differences of opinion between engagement personnel and specialists?
- Requires and maintains appropriate documentation of the results of consultations, including, if applicable, considerations involved in the resolution of differences of opinion?
- Maintains or provides access to an adequate reference library or other authoritative source?
- Adequately communicates its policies and procedures relating to consultation to all professional personnel?
- Complied with its policies and procedures for consultation during the period and adequately documented its compliance to the extent required by firm policy?

4.500 SAMPLE POLICIES AND PROCEDURES

4.501 With regard to the consultation element, *all* firms, regardless of their size, need to adopt the *theories* behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. The AICPA sample appears below. Alternative, simpler wording for local firms is provided in sections 4.503–4.505.

AICPA Sample System

4.502 The AICPA's suggested sample policies (in *italics*) and procedures on consultation read as follows:

1. *Identify areas and specialized situations where consultation is required, and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.*
 - a. Inform personnel of the firm's consultation policies and procedures.
 - b. Specify areas or specialized situations requiring consultation because of the nature or complexity of the subject matter. Examples include —
 - (i) Application of newly issued technical pronouncements.
 - (ii) Industries with special accounting, auditing, or reporting requirements.
 - (iii) Emerging practice problems.
 - (iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.
 - (v) Filing requirements of regulatory agencies.
 - c. Maintain or provide access to adequate reference libraries and other authoritative sources.
 - (i) Establish responsibility for maintaining a reference library in each practice office.
 - (ii) Maintain technical manuals and issue technical pronouncements, including those relating to particular industries and other specialties.
 - (iii) Maintain consultation arrangements with other firms and individuals where necessary to supplement firm resources.
 - (iv) Refer problems to a division or group in the AICPA or state CPA society established to deal with technical inquiries.
 - d. Maintain a research function to assist personnel with practice problems.

-
2. *Designate individuals as specialists to serve as authoritative sources, and define their authority in consultative situations. Provide procedures for resolving differences of opinion between engagement personnel and specialists.*
- a. Designate individuals as specialists for filings with the Securities and Exchange Commission and other regulatory agencies.
 - b. Designate specialists for particular industries.
 - c. Advise personnel of the degree of authority to be accorded specialists' opinion and of the procedures to be followed for resolving differences of opinion with specialists.
 - d. Require documentation of the considerations involved in the resolution of differences of opinion.
3. *Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required. Specify documentation, as appropriate, for other consultations.*
- a. Advise personnel about the extent of documentation to be prepared and the responsibility for its preparation.
 - b. Indicate where consultation documentation is to be maintained.
 - c. Maintain subject files containing the results of consultations for reference and research purposes.

Alternative Sample System

4.503 The following alternative policy (in *italics*) and procedures, are alternatives to the AICPA language. You should use it as a guide, adapting it to meet your own special needs.

4.504 *It is our firm's policy that its personnel consult, when applicable, with individuals designated to serve as authoritative consultation sources or to refer to published authoritative research sources.*

4.505 *The procedures listed below are to be followed with regard to this policy:*

1. The following special areas or specialized situations require consultation because of the nature or complexity of the subject matter:
 - a. Application of newly issued technical pronouncements;
 - b. Industries with special accounting, auditing, or reporting requirements;
 - c. Emerging practice problems;
 - d. Choices among the alternative generally accepted accounting principles when an accounting change is to be made; *and*
 - e. Filing requirements of regulatory agencies (such as the SEC).
2. A list of the firm's designated "consultants" is attached.
3. The managing partner (or quality control partner or proprietor) is responsible for maintaining the firm's accounting and auditing reference library on a current basis and for obtaining and distributing, when appropriate, newly issued professional pronouncements.
4. The managing partner (or quality control partner or proprietor) is authorized to refer consultation problems to the AICPA or our state's consultation committee or other source when a decision cannot be reached by the in-firm consultants and/or by reference to published authoritative sources.
5. The managing partner (or quality control partner or proprietor) is responsible for resolving differences of opinion among consultants and engagement personnel.
6. With regard to all consultations or references to the firm's library or outside sources, the following minimal documentation is to be placed in the file:
 - a. Identification of the particular problem or situation;
 - b. Copies of the authoritative sources to which we have referred, with the applicable sections highlighted; and
 - c. The conclusions reached, along with the reasons therefor.

7. The managing partner (quality control partner or proprietor) will maintain copies of the consultation documentations, by subject, so that the firm can resolve similar situations with a minimal use of additional investigatory procedures in the future.

4.600 SAMPLE DOCUMENTATION AND EXHIBITS

4.601 You should identify and list in-house "consultants" upon whom your staff can rely, along with their areas of expertise (section 4.603).

4.602 Your documentation must record consultants with reference materials or with other persons or firms, including a description of the problem and the conclusions reached (section 4.604).

Sample List of In-Firm Consultants

4.603 (To be typed on your firm's internal memorandum paper.)

JONES & SMITH, CPAs

List of In-Firm Accounting and Auditing Consultants

January 1, 19X3

Our in-firm consultants and their areas of expertise are listed below:

H. JONES, Partner:

1. All areas of GAAP and GAAS, including newly issued and emerging issues.
2. Prospective financial statements.

B. SMITH, Partner:

1. Construction contractors.
2. Common interest realty associations.

R. BROWN, Manager:

1. Hospitality industry.
2. SEC matters.

Note: Keep this list basic. Don't make it a promotional or "puffing" tool. Only list those consultants who actually will be used on the specific engagements. Also remember, one or two engagements don't necessarily make an "expert."

Consultation Form
Client: _____ Financial Statement Date: _____

Reviewed by: _____ Date: _____
[Engagement Partner]

Exhibits — Accounting and Auditing Reference Library

4.605 Actual peer reviews have shown that lack of access to an adequate, up-to-date accounting and auditing library is one of the consultation problem areas.

4.606 Someone within your firm (such as the managing partner, quality control partner, or proprietor) should be responsible for maintaining (or ensuring access to) an adequate accounting and auditing reference library and making sure it is updated on a timely basis.

4.607 The following three exhibits list the suggested audit and accounting literature to be included in a firm's accounting and auditing library.

4.608

Exhibit 1

Nongovernmental Accounting and Auditing Reference Library
(Authoritative and Nonauthoritative)

Title	Content	Title	Content
<i>FASB Accounting Standards/Current Text</i> <div> Available as: Loose-leaf service, software, and annual paperback Members order loose-leaf and paperback from AICPA Order software from FASB </div>	Current authoritative accounting standards arranged by subject: FASB statements and interpretations APB opinions AICPA accounting research bulletins FASB technical bulletins AICPA accounting interpretations Published in two columns: Volume 1— <i>General Standards</i> Volume 2— <i>Industry Standards</i> Topical index of above standards and EITF pronouncements and "Qs and As" published by the FASB staff	<i>FASB EITF Abstracts</i> <div> Available as: Loose-leaf service, software, and annual paperback Order from FASB </div>	Summarizes the proceedings of the emerging issues task force
<i>FASB Original Pronouncements</i> <div> Available as: Loose-leaf service, software, and annual paperback Members order paperback from AICPA Order loose-leaf and software from FASB </div>	Full text of original pronouncements arranged chronologically: Volume 1: FASB statements Volume 2: FASB interpretations APB opinions AICPA accounting research bulletins FASB technical bulletins AICPA interpretations FASB concepts statements Includes background information and rationale for conclusions Identifies superseded paragraphs and pronouncements Topical index identical to <i>FASB Current Text</i>	<i>FASB Qs & As</i> <div> Available as: Software Paperback edition for each guide Order from FASB </div>	Implementation guides (Q & A format) published by the FASB staff on: FASB no. 87 (pension costs) FASB no. 88 (settlements and curtailments of pension plans and termination benefits) FASB no. 91 (nonrefundable fees and costs of lenders and initial direct costs of leases) SFAS no. 106 (postretirement benefits other than pensions) SFAS no. 109 (income taxes) Other FASB Qs & As contained in: <i>FASB Highlights of Financial Reporting Issues:</i> SFAS no. 80 (futures contracts) SFAS no. 86 (computer software) SFAS no. 114 (impairment of a loan) <i>EITF Abstracts — Appendix D</i> SFAS no. 113 (reinsurance) — see topic D-34
		<div> Order from FASB or request from AICPA library </div>	

(Continued)

(Continued)

Title	Content	Title	Content
<i>AICPA Professional Standards</i>	Volume 1: Auditing standards Attestation standards Volume 2: Accounting and review services Code of professional conduct Bylaws International accounting International auditing Management consulting Standards for Performing and Reporting on Peer Review Services Personal Financial Planning Quality control Tax practice	<i>AICPA Technical Practice Aids</i>	Volume 1: Technical hotline Qs & As Volume 2: AICPA statements of position AICPA practice bulletins List of AICPA issues papers
<div>Available as: Loose-leaf service, software, and annual paperback Order from AICPA</div>		<div>Available as: Loose-leaf service, software, and annual paperback Order from AICPA</div>	
<i>AICPA Audit and Accounting Guides</i>	General Audit Risk Alert and Compilation and Review Alert (both updated annually) Also: Includes accounting standards for specialized industries: Agribusiness Banks and Savings Institutions Casinos Construction Contractors Credit Unions Employee Benefit Plans Federal Government Contractors Finance Companies Health Care High Technology Enterprises Insurance Companies Investment Companies Not-for-Profit Organizations Oil and Gas Producers Real Estate Companies Securities State and Local Governments Updated by: Audit risk alerts (published annually)	<i>International Accounting and Auditing Standards</i>	Includes chronological listing of statements of international accounting standards Comparison to GAAP included for each standard Chronological listing of statements of international accounting standards, including a comparison to GAAP for each standard Codification of international standards on auditing, including a comparison to GAAS for each standard Codification of international statements on auditing
<div>Available as: Loose-leaf service (includes audit risk alerts and EDs), software, paperback edition for each industry Audit risk alert and EDs also available as separate pamphlets Order from AICPA</div>		<div>Included in Volume 2 of AICPA Professional Standards Also included in AICPA Professional Standards software Order from AICPA</div>	

4.609

Exhibit 2
Governmental Accounting and Auditing Reference Library
 (Authoritative and Nonauthoritative)

Title	Content	Title	Content
<i>Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 1994</i> <div>Available as: Paperback Order from GASB</div>	Current authoritative accounting and financial reporting standards for state and local governmental entities Pronouncements included: GASB and National Council on Governmental Accounting (NCGA) statements and interpretations GASB technical bulletins GASB concepts statements Topical index	<i>GASB Qs & As</i> <div>Available as: Paperback edition for each guide Order from GASB</div>	Implementation guides (Q&A format) published by the GASB staff on: GASB Statement no. 3 (cash deposits and investments) GASB Statement no. 9 (reporting cash flows for proprietary funds) GASB Statement no. 10 (risk financing and related insurance issues) GASB Statement no. 14 (the reporting entity)
<i>Original Pronouncements: Governmental Accounting and Financial Reporting Standards as of June 30, 1994</i> <div>Available as: Paperback Order from GASB</div>	Full text of original pronouncements in chronological order: GASB and NCGA statements and interpretations GASB technical bulletins GASB concepts statements Excerpts from selected AICPA documents Includes basis for conclusions on GASB pronouncements Superseded paragraphs shaded Superseded pronouncements omitted Topical index for both original pronouncements and the codification	<i>AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units</i> <div>Included in <i>Audit and Accounting Guides</i> loose-leaf service and software Also available as paperback Order from AICPA</div>	The accounting principles specified in this guide have been codified by the GASB. Accounting developments updated by an annual audit risk alert for state and local government units
<i>Government Auditing Standards ("yellow book")</i> <div>Available as: Paperback Order from GAO</div>	Standards for audits of government organizations, programs, activities and functions, and of government funds received by contractors, not-for-profit organizations, and other nongovernment organizations.		

4.610

Exhibit 3

AICPA Other Nonauthoritative Accounting and Auditing Reference Literature

Title	Content	Title	Content
<i>Disclosure Checklists and Illustrative Financial Statements</i> ✓	Checklists of disclosure and reporting matters for various entities and industries; includes illustrative financial statements Available as: Annual paperback for each industry Loose-leaf service, entitled <i>Financial Statement Preparation Manual</i> , includes all industries Software (available on Audit Program Generator 2)	<i>Audit and Accounting Manual</i>	Includes sample workpapers and reports for audits, reviews, and compilations Available as: Loose-leaf service Annual paperback
<i>Accounting Trends and Techniques</i>	Annual survey of accounting and reporting practices followed in 600 stockholder reports Available as: Annual paperback Software	<i>Preparing and Reporting on Cash- and Tax-Basis Financial Statements</i>	Includes example financial statements and disclosures Available as: Paperback
<i>Financial Report Surveys</i>	Illustrations of the application of specific technical pronouncements Available as: Separate paperback for each topic	<i>Professional Accounting in Foreign Countries Series</i>	Description of accounting principles in various foreign countries and a comparison with U.S. GAAP Available as: Series of booklets, generally revised every three years
<i>Integrated Practice System Engagement Manuals</i>	Manuals used to manage and perform engagements efficiently, including accounting and reporting checklists and illustrative financial statements Available as: Loose-leaf volumes updated annually Checklists and audit programs also available on software (Audit Program Generator 2). Sample reports also available on WordPerfect diskettes	<i>Index to Accounting and Auditing Technical Pronouncements</i> ✓	Indexes pronouncements of the AICPA, FASB (including EITF), GASB, SEC, and other professional and regulatory bodies Available as: Annual paperback and software: electronic index to technical pronouncements (EITP)
		Comprehensive Engagement Manual Small Business Audit Manual Compilation and Review Manual Not-for-Profit Organizations Audit Manual Quality Control Manual for CPA Firms Bank Audit Manual Credit Union Audit Manual Construction Contractors Audit Manual Auto Dealership Engagement Manual	

This list is not intended to be all-inclusive.

✓ = Contains materials applicable to state and local governments

CHAPTER 5

SUPERVISION

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CHAPTER 5

SUPERVISION

5.000 WHAT "SUPERVISION" MEANS

5.001 Supervision is the most important of all the quality control elements because it encompasses the specific engagement performances, including engagement planning and final review as well as field work and supervision.

5.002 Under the American Institute of Certified Public Accountants' (AICPA's) quality control standards, supervision includes any and all policies and procedures that an accounting and auditing firm must adopt and implement, and with which it must ensure compliance, in order to adhere to professional authoritative pronouncements and standards. Therefore, supervision as a quality control element encompasses overseeing not only engagement staff but also the firm's entire approach to engagements — from planning to time budgets, to work programs, to field work, to review, to the report.

5.003 You must establish, and comply with, policies and procedures for the planning, conduct, supervision, and review of work at all levels to provide reasonable assurance that all work performed meets your firm's, and the profession's standards. If no one in your firm can review your work or the work of your staff, you should consider hiring someone capable of doing so on an hourly or contract basis. You must also document your *entire* engagement planning process.

Note: Without question, most of the comments arising during peer reviews relate to the area of supervision.

5.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

5.101 SQCS No. 1. Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to supervision:

Policies and procedures for the conduct and supervision of work at all organizational levels should be established to provide the firm with reasonable assurance that the work performed meets the firm's standards of quality. The extent of supervision and review appropriate in a given instance depends on many factors, including the complexity of the subject matter, the qualifications of the persons performing the work, and the extent of consultation available and used. The responsibility of a firm for establishing

procedures for supervision is distinct from the responsibility of individuals to adequately plan and supervise the work on a particular engagement.

Practice Tip:

Supervision is the one quality control element with which practitioners have had the most experience because they are used to doing field work and generating workpaper files.

However, you may need to fill in many important gaps — for example, documenting much of the planning process. But supervision is the area in which you probably have already, without realizing it, expended the greatest amount of effort and concentration.

5.102 Code of Professional Conduct. In particular, you must consider ET sections 201 and 202 of the Code of Professional Conduct. These rules give you an overriding ethical framework for the consideration of supervision.

5.103 ET Section 201. This section (entitled "General Standards") reads:

A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

- A. Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- B. Due Professional Care. Exercise due professional care in the performance of professional services.
- C. Planning and Supervision. Adequately plan and supervise the performance of professional services.
- D. Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

5.104 ET Section 202. This section (entitled "Compliance with Standards") reads:

A member who performs auditing, review, compilation, management consulting, tax or other professional services *shall comply with standards promulgated* by bodies designated by Council. [Emphasis added.]

5.105 SAS No. 25. Some portion of virtually every Statement on Auditing Standards (SAS) relates to engagement supervision. However, SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*, (AU 161) probably is the most important with regard to quality control. It is short but far-reaching in its implications because it is the basis of SQCS No. 1.

SAS No. 25 reads:

.01 The independent auditor is responsible for compliance with generally accepted auditing standards in an audit engagement. Rule 202 [ET section 202.01] of the Rules of Conduct of the Code of Professional Conduct of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with financial statements.

.02 A firm of independent auditors also needs to comply with generally accepted auditing standards in conducting an audit practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

.03 Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, generally accepted auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole.

5.200 HOW TO ADDRESS SUPERVISION

5.201 Your firm needs to develop some basic policies and procedures to ensure (and document) that its engagements are properly planned, executed, supervised, and reviewed, and that the financial statements that it issues are in accordance with generally accepted accounting principles (GAAP) or with an other comprehensive basis of accounting (OCBOA) in all material respects.

Basic Approach

5.202 Compliance with the supervision element entails adherence to — and therefore mastery of — the requirements set forth in the body of authoritative auditing and accounting literature. To many firms, this constitutes "standards overload." The authors believe your firm can overcome this standards overload and comply with the requirements of the accounting profession through (1) the use of certain proven tools — like engagement review and disclosure checklists, materiality computations, analytical procedures, risk assessment and engagement work programs and (2) proper consultation (see Chapter 4).



5.203 To achieve these overall goals, the authors believe you should:

1. Standardize your approach to engagements, *and*
2. Plan engagements properly before you begin field work.

Standardize Your Approach

5.204 Perhaps the simplest way to standardize your approach to your financial statement engagements is to use certain proven tools. The authors believe that the use of standardized forms will help your firm meet the objectives of the supervision element of quality control; however, your firm is not *required* to use all these forms for peer review purposes.

1. A standardized set of *workpaper guidelines*, which ensures that your workpapers for each engagement are clear, concise, and complete (sections 5.301 and 5.603);
2. A standardized *workpaper index*, which ensures that you include all required items in each engagement file (sections 5.327–5.328 and 5.605);
3. A standardized *financial statement control form*, which ensures that you obtain all important approvals for each engagement (sections 5.329 and 5.606);
4. A standardized *disclosure checklist*, which ensures that you complete all important steps, and include all important disclosures, for each engagement (section 5.330–5.332);
5. A standardized *audit planning memorandum*, which ensures that you cover all required items in planning for each engagement (sections 5.333–5.334, 5.607 and 5.608);
6. A standardized approach to understanding the *internal control structure*, which ensures that you do not overlook major items on any audit engagement (sections 5.335 and 5.608);
7. A standardized *materiality computation form*, which ensures that you consider and make the appropriate computations with regard to each engagement (section 5.342);
8. A standardized *Altman Zeta (Z) Score calculation form*, which ensures that you consider the entity's financial health and ability to continue as a going concern (sections 5.337–5.341 and 5.609);
9. A standardized *time summary and time accumulation form*, which ensures that you capture the time information necessary to demonstrate that you have *controlled* each engagement (sections 5.344–5.345, 5.610, and 5.611);
10. A standardized source (like the AICPA's Audit Program Generator) for generating the *detailed engagement programs*, which ensure that you do not overlook important objectives or steps during any engagement; *and*

11. A standardized *engagement performance review checklist*, which ensures that the engagement in-charge and partner have reviewed all files to determine that the firm complied with professional standards and with the firm's quality control standards (sections 5.346–5.347 and 5.612).

Practice Tip:

You may already realize that using these standardized tools will make it much easier for you to generate files containing the required documentation that your reviewers will expect. However, you do not need to spend time reinventing the wheel. You can choose which forms you require for your firm from the samples at the end of this chapter, and adapt them to your firm's needs.

Plan Engagements Properly

5.205 Financial statement engagements are easily divisible into three distinct phases: (1) planning, (2) field work, and (3) final review and wrap-up.

5.206 Historically, local firms have concentrated on the middle and last phases. They often have given little thought and effort to the first phase. However, by spending a little time on the *first* phase, you probably can reduce the amount of time and effort that you will have to dedicate to the time consuming second phase.

5.207 In other words, you should stop — up front — to think about what you want to accomplish, what the key elements and risks of each engagement are, and so forth. You may then be able to redirect your efforts and spend more time on the important elements while trimming back on the time you spend on the insignificant ones.

5.300 SOME TIPS AND TECHNIQUES**Develop Workpaper Guidelines**

5.301 SAS No. 41, *Working Papers*, states that an auditor must develop files to support the opinion that is rendered. Workpapers contain the only lasting written documentation of the work you perform and the conclusions reached. Workpapers must stand on their own. Therefore, workpapers should be complete with regard to:

1. All material items,
2. Sources of information obtained,
3. Scope of work performed (including cross-references to work program), *and*
4. Conclusions reached, including the reasons therefor.

5.302 You do not necessarily need to develop a specific set of sample workpapers for your practice; however, it is a good idea to have general guidelines that all firm members must follow for non-audit as well as audit engagements. Use of standardized workpaper guidelines will ensure that your workpapers are clear, concise, and complete.

5.303 Use of guidelines will result in workpapers that will speed up your internal review process and that someone from outside the firm (such as your peer reviewers) will be able to follow.

5.304 Pay particular attention to the sign-offs on each page to see whether one person is taking responsibility for preparing the paper and someone else is taking responsibility for reviewing the paper.

Practice Tip:

To produce meaningful workpapers, the preparer must decide in advance what the ultimate objective of each workpaper is, whether the necessary information is contained elsewhere in the workpapers, and so forth.

Practice Tip:

One way to save time on an engagement is to use standardized tick marks that are explained once — at the front of the engagement file — instead of on each and every workpaper. The tick mark index is also a good place to put a key to the initials of the various individuals who work on the file. Thus, they will not have to sign their complete names on each and every workpaper. A standardized initial key will make it possible to sort out the marks of different staff members who share a common set of initials, as well as to determine at a later date who worked on the file.

Comply With Professional Standards

5.305 The most common deficiencies found in actual peer reviews have been related to supervision. The most common substantive deficiencies are:

1. Planning memorandum and/or work program is inadequate or missing;
2. Analytical procedures, risk assessment, materiality, and continued existence were inadequate or not considered;
3. Client representation letters are inadequate or missing;
4. Lawyers' letters are inadequate or missing;
5. Confirmations of cash, receivables, or debt, when required, are inadequate or missing;
6. Material differences between GAAP and tax depreciation methods are not considered;
7. Roll-forward procedures are inadequate or missing when inventory has been observed or receivables confirmed at an interim date;

8. Statistical or judgmental sampling is improperly used; *and*
9. Review of workpapers was inadequate or not properly documented.

5.306 To pass its peer review, your firm must comply with the applicable professional standards. A *few* of the more notable ones are discussed below, but the materials covered simply serve as examples; they do not even *begin* to touch what someone who holds himself or herself out as having "training and proficiency as an auditor" needs to know.

Engagement Planning and Work Program

5.307 SAS No. 22, *Planning and Supervision*, lists (1) the items that might be included in an audit plan and audit program, (2) the knowledge that the auditor must obtain before beginning field work, and (3) the items that should be considered at the end of an engagement, during the final review and wrap-up phase.

5.308 All auditors should read SAS No. 22 in its entirety and be sure that they understand its content. Some planning and program problems that have resulted in quality and peer review comments are summarized below.

Internal Control Structure

5.309 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, explains how you should consider a client's internal control structure in planning and performing your audits. Your understanding of a client's internal control structure and assessment of control risk contribute quite heavily to determining the nature, extent, and timing of your procedures. Accordingly, it is a most important part of the planning process on audits.

5.310 Under SAS No. 55, it is no longer adequate merely to make a blanket statement like "we are not going to rely on the internal control structure." You must consider *each element* of the internal control structure *separately* and decide whether to rely upon that element. You must then reach, and document, an overall conclusion.

5.311 Special Control Issues. If you determine that the client's EDP system is used to process significant accounting records, you must also evaluate the EDP controls.

5.312 Consideration of the internal control structure is *required* for audits in accordance with *Government Auditing Standards* of clients like municipalities—because the auditor must issue a report on the internal control structure. This is also being considered as a requirement in all Securities and Exchange Commission (SEC) audits.

5.313 Under SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, an auditor must obtain these reports (also known as "service auditors' reports") whenever outside service bureaus are materially involved in the client's accounting function. Additionally, if specialists (e.g., actuaries) are involved in the client situation, you need to review their qualifications and work product. The same holds true for internal audit departments — if you rely on their work.

Analytical Procedures

5.314 SAS No. 56, *Analytical Procedures*, indicates that if a number is what you expect it to be, based upon reasonable assumptions, you may be able to curtail auditing procedures somewhat. In other words, if you take the time at the beginning of an engagement to think about what it is you are looking to accomplish, what you expect the numbers to be, and what they actually are, you may be able to *limit* your procedures to what is really important or out of line. You will not necessarily need to concern yourself with items that are not out of line, do not present high risks of misstatement, are not material, and the like. These preliminary analytical procedures may be documented in the Audit Planning Memorandum (section 5.607).

Practice Tip:

This approach is quite different from the audit approach of simply marching up and down the balance sheet, without much consideration about *why*. Analytical procedures can provide an efficient alternative to detailed testing of account balances. You can also use them in determining whether the numbers make sense and are plausible in view of your expectations. You should be able to limit your procedures and efforts to those areas that really need your attention, *cutting back* on those that are much as you expect. For example, if a client's sales go up, you would expect its costs of goods sold and certain related expenses to increase accordingly. If any of these numbers go *down*, or even remain the same, you have to find out why.

You must consider similar analytical factors after field work has been completed and all adjustments have been made to see if your original decisions have been validated.

You probably perform most of these analyses already in your head. Now you have to learn to reduce them to writing.

Risk Assessment

5.315 Paragraph 19 of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, says:

The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him, at the completion of his examination, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk.

5.316 Risk assessment, in conjunction with analytical procedures and consideration of materiality, helps you determine what procedures to apply, how much time and effort to give to each, and when to apply them. Risk assessment is an area in which the auditor's judgment, based on his or her experience and proficiency, becomes paramount. Factors to be considered include:

- Use(s) the client will make of the financial statements,
- Management integrity,
- Continued existence considerations, *and*
- Error likelihood.

Practice Tip:

Risk will be *different* for each client and for different elements of a particular client's financial statements. For example, one client's receivables might present a high element of risk but another's may not. Thus, you need to consider risk factors on a case-by-case basis.

Materiality

5.317 SAS No. 47 reiterates the definition of materiality, as contained in FASB's Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, as:

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Practice Tip:

Think in terms of letting risk and materiality determine what procedures you perform — don't just do what you have historically done on this — or any other — engagement.

Other Items That Require Attention

5.318 SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, states that the auditor should assess the risk that errors and irregularities may cause financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting material errors and irregularities. In addition, SAS No. 54, *Illegal Acts By Clients*, states that the auditor's responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the financial statements is the same as that for other errors and irregularities.

5.319 AU Section 334, *Related Parties*, indicates that related party transactions are an area to which you, as an auditor, should give specific attention.

Client Representation Letter

5.320 SAS No. 19, *Client Representations*, requires you to obtain a *written* client representation letter in an audit and gives illustrative language.

5.321 Under the Statements on Standards for Accounting and Review Services (SSARS), obtaining a representation letter in review engagements is also required. (See the Engagement Performance Review Checklist in section 5.612.)

Practice Tip:

Those letters normally should be dated the same day as the related auditors' or accountants' report. Often, the client types the wrong date.

Lawyers' Letters

5.322 Remember to tailor each letter to fit the specific client situation. SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states the requirements for requests for legal representation letters on audits. It also gives the wording for such requests and dictates the specific form that the responses must take. A common problem noted in actual peer reviews is lawyers' letters dated more than *two weeks* before the date of the Independent Auditor's Report. Make sure such letters get *updated* — for your own protection.

Going-Concern Considerations

5.323 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, states that the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as going concern for a one-year period from the balance-sheet date.

Audit Sampling

5.324 Many local firms have found it difficult to comply with SAS No. 39, which gives detailed explanations of what sampling is and how it should be used and evaluated. Fundamentally, you must perform an entire audit without sampling, use statistical sampling, or come up with an alternative judgmental sampling strategy that complies with SAS No. 39.

Practice Tip:

In most cases, you may be able to work around the problem. A strategy for testing without sampling is a practical alternative for small business clients.

The alternative strategy involves redefining the audit population as one that is much smaller, and probably much less material, by first extracting those items that are individually significant and that you obviously would select for audit attention. This is known as "stratification." You then determine which audit techniques are appropriate for the audit objectives relating to the remaining items in the account. If the remaining items are immaterial in the aggregate, and there are no indications of problems in the course of other audit procedures, such as analytical procedures (or in prior experience with the client), additional procedures may not be necessary. Substantive testing of related accounts may also provide evidence sufficient to eliminate additional tests.

If you do decide to test the remaining items, several alternatives could be more efficient than sampling. In some cases, you may conclude that scanning or other analytical procedures will suffice. Another alternative is to select enough additional items for 100% testing so that you reduce the remaining balance to an immaterial amount or to one that can be tested using non-sampling audit techniques. Whatever decisions you make in determining how to comply with SAS No. 39 for a particular engagement, document your conclusions and the reasons for them in your workpapers.

Use Workpapers to Properly Document Engagement Decisions

5.325 SAS No. 41, *Working Papers*, states: "The auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement." Peer reviewers have noted the following documentation deficiencies:

1. Inadequate documentation of proper engagement planning,
2. Inadequate documentation of application of analytical procedures,
3. Inadequate documentation of consideration of risk and materiality, *and*
4. Inadequate documentation of use of audit sampling.

5.326 *The following discussion explains how you can deal with these documentation issues, and avoid deficiencies being noted in your peer review, for non-audit as well as audit engagements. In effect, it walks you through the required elements of an engagement workpaper file — using the forms at the end of this chapter as a basis. It also notes a number of collateral practice management — and ultimately bottom-line — benefits in addition to explaining how and why use of proper documentation will help you pass your peer review.*

Workpaper Index

5.327 Most CPAs have been guilty, at one time or another, of keeping important information in their heads — instead of in their files. Such "walking workpapers" are not sufficient for a peer review.

Practice Tip:

The AICPA Integrated Practice System engagement manuals are effective tools for documenting your work on each engagement. The manuals are "how-to" guides designed to help you achieve the most cost-effective and efficient engagement. They cover general audits, reviews, and compilations, as well as engagements in specific industries, such as construction contractors, auto dealerships, banks, credit unions, and not-for-profit organizations. A full listing of the available manuals is presented in Chapter 4, section 4.610.

5.328 A standardized workpaper index will help you to ensure that you include all required items in each engagement file and do not overlook any important items.

Practice Tip:

You probably are familiar with most of the items in a proper workpaper file but some, particularly in the planning and administration section of the workpaper file in section 5.605, might be new to you.

It would be best to address each item in the *planning and administration* section and include it in a workpaper file for *each* client. If, for some reason or another, you do not consider one of the items to be meaningful for a particular file, you should place a memorandum or notation in that section of the file.

Example: A client has *no* related-party transactions. You should either (1) place a memorandum stating that "no related-party transactions have been noted with regard to [*name of client*]" at the appropriate point in the file and/or (2) make a notation to the same effect next to the related-party line on the workpaper index.

However, you need to consider and address all of the planning and administration items, such as planning memoranda, analytical procedures, risk assessment, materiality, engagement programs, time budgets, the entity's ability to continue as a going concern, and the like.

Financial Statement Control Form

5.329 A control form will ensure that you (1) obtain all important required approvals for each engagement and (2) document that fact. Although a prototype is helpful (see section 5.606), you should specifically tailor your own control form for your practice so that it includes only those steps that are meaningful to *your* practice and that your firm members should perform on every engagement. You then need to ensure that each step is completed on each engagement (and the sign-off entered on the appropriate line) *before* the next step is undertaken.

Practice Tip:

Among the *key things* that peer reviewers look for are (1) completion of *all* steps listed on the form in *chronological order* and (2) an absence of any significant open items remaining when the financial statements are released.

Practice Tip:

Although the case law is unclear on this issue, and constantly changing, your external distribution of financial statements should help to limit your liability with regard to them. Ideally, you should send financial statements only to your client — not to brokers, potential lenders, and the like; let your client distribute the statements to the other parties.

Disclosure Checklist

5.330 It is extremely important for you to have something in your files that (1) assists you in ensuring that you have made all required GAAP or OCBOA disclosures and that you have complied with all GAAS and SSARS requirements in all significant respects and (2) documents your compliance.

5.331 Many practitioners are loath to use the financial statement disclosure checklists available on the market today because they believe that completing approximately 30 pages of questions is unnecessary for most of their clients. But you can instead, develop your own summarized checklist that relates to *your* clientele.

5.332 The *AICPA Financial Statement Preparation Manual* contains general disclosure and reporting checklists for corporations, and also numerous other checklists including nonprofit and local governmental entities, savings institutions, employee benefit plans, real estate ventures, prospective financial statements, and Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Consensuses.

Practice Tip:

No matter what checklist you use, make sure that there is a sign-off on *each* line and that there are no holes in the checklist once the financial statements are issued.

Audit Planning Memorandum

5.333 A planning memorandum is designed to (1) document the overall approach a firm plans to take for a particular engagement, along with the reasons therefor, and (2) communicate that approach to the professional staff members who will work on the engagement. Consider including in your workpapers some sort of documentation, such as a specifically tailored summary memorandum for each financial statement client situation (see sections 5.607 and 5.608).

5.334 Although this important document should be customized for *each* engagement, reference to a standardized list of items to be included will ensure that you will include all of the items for each engagement. The memorandum should normally include sections encompassing items such as:

1. The approach your firm will take to the engagement, including:
 - Understanding of the client's internal control structure;
 - Preliminary decisions about results of analytical procedures, risk, materiality, and auditability;
 - Identification of those key issues or areas requiring the greatest amount of attention; *and*
 - Other specific or unusual areas of emphasis, including requirements for first-year engagements;
2. Firm personnel assigned to the engagement;
3. Timing of work; *and*
4. Any other items of significance.



Internal Control Structure Documentation

5.335 Your audit planning process must include documentation of your understanding of the client's internal control structure and a conclusion as to the assessed level of control risk. If control risk is assessed below the maximum, the basis thereof should be documented in the planning memorandum in a manner similar to that presented in section 5.608. Documentation of your understanding of the control structure should follow a standardized approach, such as a simple questionnaire, to ensure that you do not overlook major items.

Analytical Procedures

5.336 SAS No. 56 requires the use of analytical procedures both as part of planning and as part of the final overall engagement evaluation.

Altman Z Score

5.337 The Altman Z Score, developed by Edward I. Altman,* is a composite formula that is widely used to measure the financial health of a company. The formula takes financial ratios and multiplies each by a specific constant. The computed amounts then are added together to obtain an overall score. If the total Z Score determined under this calculation exceeds 2.6, the entity probably can be considered sound and secure. If less than 1.1, long-range survival prospects may be in question.

5.338 The Z Score can be computed on the Altman Z (Zeta) Score Calculation Form in section 5.609. This score then is compared to scores from other entities to rate relative financial health. Also, the trend of the Z Score should be analyzed to determine whether or not a problem may be developing.

5.339 You should consider calculating the Z Score when you become aware of conditions and events that may raise a question about the entity's ability to continue as a going concern. (See SAS No. 59.)

5.340 Because the Z Score is only one means of measuring an entity's financial health, your firm's quality control policies and procedures should indicate under what conditions, if any, you would make this calculation.

5.341 The results of the Z Score would be documented in the Client Acceptance and Continuance Form and in the Audit Planning Memorandum.

Materiality Computation

5.342 Your financial statement files need only address material matters — that is, those items that help influence the opinion that you will be rendering on the financial statements. Materiality is a planning issue that you need to consider on *every* audit engagement before field work begins. Use of a standardized form for computing materiality thresholds will ensure that you consider the appropriate computations.

* Source: Altman, Edward, *Corporate Financial Distress: A Complete Guide to Predicting, Avoiding, and Dealing With Bankruptcy*, 1983, John Wiley & Sons.

5.343 You also need to readdress the materiality threshold toward the end of the engagement — to see if the adjustments you made took your base numbers *below* what you had originally thought they would be.

Time Summary

5.344 The ability to budget for engagements properly is considered an example of the ability to control them, and, therefore, evidence of proper supervision. The existence of accurate time records will also greatly facilitate the task of compiling information about hours that your peer reviewers will need to help them select the engagements that they will be reviewing. Use of a standardized time summary form (section 5.610) and a time accumulation sheet (section 5.611) will ensure that you capture the time information necessary to demonstrate that you have *controlled* the engagement. These forms also provide evidence about how your firm expended its engagement effort and *whether you gave enough attention to the key areas*. Thus, although not specifically required by GAAS, you will find it beneficial in administering your practice and supervising your engagements to keep detailed time records.

5.345 You should prepare a budget *before* you start an engagement and later reconcile it to the actual time spent on the engagement, giving detailed explanations of significant variances. Following these procedures will also help you bill for excess time and budget future work more accurately.

Practice Tip:

Never force a staff member to reduce a budget estimate to meet an agreed-upon fee. Accept the fact that your staff members know what they, and you, are doing; you may have to absorb a "loss" in order to permit your staff to do a good job. Forcing them to reduce a budget is also a definite morale breaker.

Engagement Performance Review Checklist

5.346 This checklist documents the review responsibilities of the in-charge and engagement partner. The in-charge is responsible for reviewing the work of all assistants to determine that sufficient evidence was gathered to accomplish the engagement objectives. (See section 5.612.)

5.347 The engagement partner should review the engagement working papers, work programs, and checklists to the extent required by firm policy. The partner also should review the financial statements and the independent auditor's (or accountant's) report for appropriate form and conformity with professional standards.

Make Sure That Reporting is Sufficient

5.348 Some of the most common reporting deficiencies noted in actual peer reviews are:

1. Auditor's reports lack a title including the word "independent;"
2. Accompanying information was not covered in auditor's or accountant's report;

3. Disclosures about related party transactions were missing or inadequate;
4. Disclosures about pension plans were missing or inadequate;
5. Disclosures about leases were missing or inadequate;
6. Disclosures about current and deferred income taxes were missing or inadequate;
7. Disclosures about five-year debt maturities were missing;
8. Debt was improperly classified on the balance sheet;
9. Disclosure of concentrations of credit risk were missing;
10. No documentation of any communication about reportable conditions was noted in the workpapers concerning internal control structure matters; *and*
11. Statements of cash flows prepared under the indirect method lacked supplemental disclosures of cash paid for interest and income taxes.

To pass its peer review, your firm must comply with all applicable reporting standards.

Make Sure Nonaudit Engagements Also Comply With Professional Standards

5.349 Your peer review will cover *all* types of financial statements that you issue (not just those that were audited). Therefore, you also will need to make sure that you are in complete compliance with the requirements of the SSARS and of the Statements on Standards for Attestation Engagements.

5.350 Actual peer review experience shows that the following supervision-related problems are the most common with regard to non-audit engagements:

1. Accountant's report did not properly report on all periods presented (including the comparative "current month" column in computer-generated financial statements);
2. Financial statements and accountant's report used inappropriate titles for OCBOA financial statements (cash basis, income-tax basis, etc.);
3. Interim GAAP-basis financial statements omitted income tax provision, depreciation, or interest;
4. No disclosure was made (either in the notes or the accountant's report) of the basis of OCBOA financial statements and the fact that they are not intended to represent GAAP;
5. Financial statements did not conform to accounting or reporting and disclosure requirements of specialized industries;
6. Financial statements omitted required disclosures, particularly in the areas of concentrations of credit risk, supplemental cash flows information, related parties, leases, and long-term debt;
7. GAAP-basis financial statements did not include a cash flows statement for every period for which an income statement was presented;
8. Accountant's report did not cover supplementary information;

9. The accountant's compilation report paragraph that describes the omission of substantially all disclosures included inappropriate references to GAAP, "financial position," or "results of operations" when OCBOA financial statements were presented;
10. Each page of compiled or reviewed financial statements did not include a reference to the accountant's report;
11. Financial statements did not include or improperly presented deferred income taxes;
12. Financial statements included improper classification of noncurrent assets as current or demand notes payable as long-term;
13. Accountant's report language did not include the elements required by SSARS; *and*
14. Inconsistencies existed between titles stated in the accountant's report and those actually used on the financial statements.

5.351 Most importantly, you must make sure that your accountant's reports on reviewed and compiled financial statements are appropriately worded. If, for example, the client is issuing an income-tax basis financial statement, you must make sure that your accountant's report is appropriately worded and that you do not create the impression that the statement is really a GAAP-basis statement.

5.352 Regarding your financial statement clients, make sure you have in each engagement file the appropriate work programs, checklists, representation letters, indications of partner review and satisfaction with the final products, and so forth.

Use Concurring Reviews

5.353 Many of the problems that have been noted in peer reviews, and that are closely associated with all of the matters discussed above, can be minimized by a concurring (or cold or second) review. Although a concurring review is not required—except on an SEC engagement—you will find it produces significant benefits.

5.354 When you have almost completed an engagement, it is most important for you to step back a bit and make an overall decision about whether the evidence gathered adequately documents the *opinion* that you are rendering on the financial statements. A concurring review helps accomplish this for you.

5.355 The peer review process shows that such reviews have considerable value. Concurring reviews *consistently* find important items that were initially overlooked—because the engagement team, including the engagement partner, was in too much of a hurry—or was too much into the trees to see the forest. If you do not use concurring reviews, your peer reviewer is much more likely to find numerous supervision deficiencies than if you do use concurring reviews.

Practice Tip:

Any firm with two or more technically competent partners can probably provide reviews for each other. However, if you are a sole practitioner, or if your partners are mostly tax-oriented, you may have a problem. There are three easy ways to overcome this:

1. Delegate responsibility to a technically proficient staff member,
2. Make a reciprocal arrangement with another sole practitioner in a situation similar to yours for reviews of each other's financial statements and files, *or*
3. Hire a consultant who provides this service to firms like yours (see Chapter 4).

Retain Your Objectivity and a "Sense of Professional Skepticism"

5.356 Auditing and financial statement services *differ* from some of the other traditional services that you render to your clients (such as tax advice and tax return preparation). With regard to many of those other services that you render, you are looking to "help" the client seek the position that is *most beneficial* to them. You are their "friend" — their *advocate*.

5.357 This is *not true*, however, when you are their financial statement preparer or their *auditor*. You are *required* by professional guidelines, when you are acting in these situations, to retain your *objectivity* and a "*sense of professional skepticism*." You *must* be sure that the numbers, as finally reflected in the financial statements, tell it "like it is"—which is not necessarily like the client wants it to be.

5.358 This is sometimes a very difficult concept for practitioners to explain to their clients. In fact, you may even be auditing the very same transaction that you helped structure only a few weeks ago! Unless you are working on an SEC engagement, there is no problem with that—as long as you recognize that certain things that might be acceptable for tax reporting purposes may *not* be acceptable for financial reporting (GAAP) purposes. That's what "temporary differences" are all about!

5.359 Professional skepticism is also a required attitude in complying with SAS Nos. 53 and 54 (see section 5.318).

5.360 However, the most important thing for you to remember in this regard, is, when serving as an auditor, retain and maintain your objectivity—"audit" items—don't just accept them blindly.

5.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE SUPERVISION ELEMENT

5.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire. (See section 2.700 in Chapter 2):

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due

consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Has established appropriate procedures for planning engagements?
- Has established appropriate procedures for maintaining the firm's standards of quality, including:
 - Guidelines for the form and content of working papers?
 - Standardized forms, checklists, questionnaires, and other guidance materials to the extent appropriate?
 - Adequate supervision at all organization levels?
 - Procedures for resolving differences of professional judgment among the engagement team?
- Has established appropriate procedures for reviewing engagements and for the documentation thereof?
- Adequately communicates its policies and procedures relating to supervision to all professional personnel?
- Complied with its policies and procedures for supervision during the period and adequately documents its compliance to the extent required by firm policy?
- Conformed with professional standards during the period in the performance of the accounting and auditing engagements selected for review?

5.500 SAMPLE POLICIES AND PROCEDURES

5.501 With regard to the supervision element, *all* firms, regardless of their size, need to adopt the *theories* behind, but not necessarily the exact wording of, the AICPA's sample policies and procedures. The AICPA sample appears below. Alternative, simpler wording is provided in section 5.503–5.504.

AICPA Sample System

5.502 The AICPA's suggested sample policies (*in italics*) and procedures on supervision read:

1. *Provide procedures for planning engagements.*
 - a. Assign responsibility for planning an engagement. Involve appropriate personnel assigned to the engagement in the planning process.
 - b. Develop background information or review information obtained from prior engagements and update for changed circumstances.
 - c. Describe matters to be included in the engagement planning process, such as the following:



- (i) Development of proposed work programs.
 - (ii) Determination of manpower requirements and need for specialized knowledge.
 - (iii) Development of estimates of time required to complete the engagement.
 - (iv) Consideration of current economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement.
2. *Provide procedures for maintaining the firm's standards of quality for the work performed.*
- a. Provide adequate supervision at all organizational levels, considering the training, ability, and experience of the personnel assigned.
 - b. Develop guidelines for the form and content of working papers.
 - c. Utilize standardized forms, checklists, and questionnaires to the extent appropriate to assist in the performance of engagements.
 - d. Provide procedures for resolving differences of professional judgement among members of an engagement team.
3. *Provide procedures for reviewing engagement working papers and reports.*
- a. Develop guidelines for review of working papers and for documentation of the review process.
 - (i) Require that reviewers have appropriate competence and responsibility.
 - (ii) Determine that work performed is complete and conforms to professional standards and firm policy.
 - (iii) Describe documentation evidencing review of working papers and the reviewer's findings.

(Documentation may include initialing working papers, completing a reviewer's questionnaire, preparing a reviewer's memorandum, and employing standard forms or checklists.)
 - b. Develop guidelines for review of the report to be issued for an engagement. Considerations in (a), above, would be applicable to this review. In addition, the following matters should be considered for these guidelines.
 - (i) Determine that the evidence of work performed and conclusions contained in the working papers support the report.
 - (ii) Determine that the report conforms to professional standards and firm policy.
 - (iii) Provide for review of the report by an appropriate individual having no other responsibility for the engagement.

Alternative Sample System

5.503 The following sample system (*in italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is included in parentheses.

5.504 *It is our firm's policy to ensure that its financial statement engagements are subject to appropriate planning, supervision, and review.*

The procedures listed below are to be followed with regard to this policy:

1. During the planning of each engagement, we obtain and/or document the following items, which are to be approved by the partner in charge of the engagement:
 - a. Our knowledge of the client and its industry.
 - b. Our satisfaction that appropriate financial books and records exist, are properly and timely maintained, and reflect the activities of the client, including any peculiarities of its industry.
 - c. On audits, our consideration of the various elements of the client's internal control structure — including corrections of previously noted deficiencies—and our conclusions about the assessed level of control risk for each assertion. (If control risk is assessed at below the maximum, the basis for such conclusion also should be documented.)
 - d. Engagement letter.
 - e. Audit planning memorandum.
 - f. On audits, assessment of risk.
 - g. On audits and reviews, preliminary analytical procedures.
 - h. On audits, materiality computation.
 - i. Consideration of independence and approval of rendering of service for current year.
 - j. Time budget.
 - k. Detailed engagement program that is responsive to engagement objectives and, on audits, internal control structure deficiencies.
 - l. On audits, any sampling plans and confirmation procedures that we will use.
2. During the field work phase of each engagement, the engagement partner is to supervise engagement personnel and communicate with the staff about all important items. As part of this process, the engagement partner must ensure that the engagement staff follows the procedures set forth below and documents compliance with them:
 - a. Adhering to—or re-evaluating—the planning memorandum, risk assessment, materiality threshold, time budget, engagement program, and sampling plans.
 - b. Obtaining or developing proper supporting schedules for all significant accounts on audits and reviews.
 - c. Obtaining client and legal representation letters.

- d. Considering material subsequent events and cutoff procedures.
 - e. Considering the entity's ability to continue as going concern.
 - f. Conducting necessary consultations and research.
3. During the wrap-up phase of each engagement, the following procedures are to be followed and compliance with them is to be documented:
- a. Performance and evaluation of overall analytical procedures.
 - b. Evaluate going-concern considerations.
 - c. Evaluation of the planning memorandum, risk assessment, materiality threshold, time, budget, engagement program, and, on audits, sampling plans and confirmation procedures to determine if the original conclusions remain valid in view of all circumstances encountered in the engagement.
 - d. Overall evaluation of all of the evidence obtained to determine if it supports the opinion to be rendered on the financial statements.
 - e. Review of material financial statement disclosures to ensure that they are in accordance with GAAP.
 - f. On audits, inclusion of major internal control structure deficiencies in the current reportable conditions form.
 - g. Engagement partner approval of all significant items.
 - h. On audits and reviews, a concurring review of the financial statements—and selected files and key workpapers—by a partner (or equivalent) not otherwise associated with the engagement.
 - i. If we are relying on the work of other auditors, documentation of our satisfaction that their work is conducted in accordance with GAAS.

5.600 SAMPLE DOCUMENTATION

5.601 You probably will want to standardize your entire approach to your financial statement engagements by adapting these proven tools to your practice:

- A standardized set of *workpaper guidelines*, which ensures that your workpapers for each engagement are clear, concise, and complete (section 5.603);
- A standardized *workpaper index*, which ensures that you include all required items in each engagement file (section 5.605);
- A standardized *financial statement control form*, which ensures that you obtain all important approvals for each engagement (section 5.606);
- A standardized *disclosure checklist*, which ensures that you complete all important steps, and include all important disclosures, for each engagement (section 5.330–5.332);

- A standardized *audit planning memorandum*, which ensures that you cover all required items in planning for audit engagements (sections 5.607 and 5.608);
- A standardized approach to understanding the *internal control structure*, which ensures that you do not overlook major items on any audit engagement (sections 5.335 and 5.608);
- A standardized *materiality computation form*, which ensures that you consider and make the appropriate computations with regard to each engagement;
- A standardized *Altman Zeta (Z) Score Calculation form*, which ensures that you consider the entity's financial health and its ability to continue as going concern (5.609);
- A standardized *time summary form and time accumulation form*, which ensures that you capture the time information necessary to demonstrate that you have *controlled* each engagement (sections 5.610 and 5.611);
- A standardized source (like the AICPA's Audit Program Generator) for generating the *detailed engagement programs*, which ensures that you do not overlook important objectives or steps during any engagement; *and*
- A standardized *engagement performance review checklist*, which ensures that the engagement in-charge and partner have reviewed all files to determine that the firm complied with professional standards and with the firm's quality control standards (section 5.612).

Suggested Minimum Documentation

5.602 At a *minimum*, your firm should document the following with regard to each engagement (or, when noted, each audit engagement):

1. Engagement planning steps (sections 5.607 and 5.608);
2. On each audit engagement, obtain an understanding of the internal control structure (sections 5.607 and 5.608);
3. Analytical procedures;
4. Risk assessment (on audit engagements);
5. Materiality considerations;
6. Evaluation of the entity's financial health and going-concern considerations (section 5.609);
and
7. Engagement performance reviews (section 5.612).

Workpaper Guidelines

5.603 Objectives. Workpapers contain the only lasting written documentation of the work performed. They are the evidence on which the report rendered is based. Accordingly, engagement workpapers must communicate the entire story effectively. Therefore, they should be complete with regard to:

1. All material items,
2. Sources of information obtained,
3. Scope of work performed (including cross-references to engagement program), *and*
4. Conclusions reached, particularly on audits, including reasons therefor.

5.604 Guidelines

1. Workpapers should be neat, self-explanatory, and easily understood by a "cold" reader. There should be no need to ask a preparer a question about a workpaper.
2. Both the preparer and the reviewer should sign and date workpapers — to indicate that the workpapers are complete.
3. A standard tick mark and initial index, which will save the time of repeating the explanations on each separate workpaper, should be included at the front of the workpaper file.
4. A conclusion statement, such as the following, should be used on all major audit schedules:

"Based on audit procedures performed and results thereof, [*name of item*] appears to be fairly stated in all material respects."
5. Profit and loss account should be analyzed, when appropriate, on the workpaper of the related asset or liability.
6. All material accounts should be analyzed (on audits and reviews).
7. When a workpaper is transferred to another file, a copy should be placed in the old file.
8. Immaterial journal entries should not be made—unless we are specifically paid to do so.
9. Extreme care should be used in preparing drafts for typing. Preparers should not assume reviewers or typists will edit their work. Preparers should especially note underlines, indentations, capitalization, spelling, headings, margins, dollar signs, and punctuation.
10. All significant incomplete items should be listed on an open item list on the control sheet when workpapers are submitted for review. Open items should be resolved as expeditiously as possible; they must be completed before release of the financial statements. The staff person and reviewer must sign off on a subsequently completed item, and date the sign-off, before placing the additional items in the file.
11. Responses to review notes should indicate briefly what was done and refer to where the results can be found in the workpapers. The actual answers to the review notes should be incorporated directly into the workpapers so that the completed workpapers will stand on their own. The review notes should then be returned to the reviewer for clearing and disposition before the statements are processed. Review notes should not be retained after they are cleared.

5.605

Workpaper Index
Client: _____
Financial Statement Date: _____

Final Products

Financial Statements (Including Related Support and Control Form)	AA
Management Letter (Including Related Support and Control Form)	BB*

Planning and Administration

Review and Disclosure Checklists	A
Engagement Letter	B
Planning Memorandum	C
Internal Control Structure	D*
Analytical Procedures	E**
Risk Assessment	F*
Materiality	G**
Time Summary	H**
Detailed Work Program	I**
Representation Letters	
Client	J**
Legal	K*
Consideration of Continued Existence	L
Related Parties	M
Cutoffs	N
Confirmation Control	O*
Tick Mark and Initial Index	TM**

Trial Balance and Adjustments

Working Trial Balance	TB
Adjusting Entries	JE
Reclassification Entries	RE
Passed Adjustments Summary	PE**
Closing Entries	CE
Post Closing Trial Balance	PC

Assets

Cash	1
Investments	2
Receivables	3
Inventories	4
Prepayments	5
Property and Equipment	6
Intercompany	7
Other Assets	8

Liabilities and Equity

Notes and Loans Payable	10
Payables and Accruals	20
Income Taxes	30
Other Liabilities	40
Equity (Including Minutes)	50

Operations

Revenues	100
Expenses	200

Instructions

1. Neatly cross out inapplicable lines or circle applicable ones.
2. *Applicable to audits only.
3. **Applicable to audits and review only.
4. If any items are in other files, so indicate.

5.606

Financial Statement Control Form
Client: _____
Financial Statement Date: _____

INSTRUCTIONS: This form should be prepared by the in-charge to accompany the draft of the financial statements and report. Each step should be initialed and dated as it is completed, or checked "N/A." Step 8 must be initialed and dated by the engagement partner in order to release the financial statements and report.

SERVICE PERFORMED:

AUDIT ☐

REVIEW ☐

COMPILATION ☐

	<u>Performed By</u>		<u>N/A</u>
	<u>Initials</u>	<u>Date</u>	
1. Submit financial statements and report to typing.	_____	_____	
2. Proofread the financial statements and report.	_____	_____	
3. Resubmit the financial statements and report for correction.	_____	_____	<input type="checkbox"/>
4. Submit to technical reviewer, if applicable.	_____	_____	<input type="checkbox"/>
5. Resubmit the financial statements and report for corrections.	_____	_____	<input type="checkbox"/>
6. Foot and crossfoot all pages.	_____	_____	
7. Submit to engagement partner for final review.	_____	_____	
8. Release the financial statements and report.	_____	_____	

Number of Copies:

Bound: _____ Unbound: _____

Other: _____

5.607

Audit Planning Memorandum

Client: _____

Financial Statement Date: _____

INSTRUCTIONS:

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner, before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION**A. Presentation of Engagement Letter**

B. Use of Client Assistance or Paraprofessionals

C. Planning for Proper Workspace and Equipment

D. Assignment of Staff

E. Target Dates

Start of interim field work	_____
Start of year-end field work	_____
Audit report	_____
Management letter	_____
Tax returns	_____
Other	_____

F. Use of Specialists

G. Use of Audit Software

H. Audit Budget

I. Other Considerations

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk

◆

B. Understanding of Internal Control Structure

C. Overall Materiality Limit

D. Sampling

E. Audit Approach

F. Key Engagement Area(s)

G. Planning Analytical Procedures

H. Other Considerations

Prepared by: _____ Date: _____
(In-Charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

5.608

Audit Planning MemorandumClient: XYZ Company, Inc.Financial Statement Date: December 31, 19XX**INSTRUCTIONS:**

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner, before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION**A. Presentation of Engagement Letter**

On September 1, 19X, Monty Manager presented our engagement letter to Samantha Ryan, CEO. He discussed the nature of our audit services and the client's responsibility to provide an adjusted trial balance and supporting schedules by January 21, 19Y.

Before preparing the letter, he reaffirmed that our firm is independent with regard to XYZ and that there is no reason for us not to continue to service this client.

B. Use of Client Assistance and/or Paraprofessionals

Client will prepare schedules listed on an attachment to engagement letter. Chief accountant was given standard working papers and copies of last year's papers on September 15, 19X. Client will provide one clerical person during field work for our use to pull invoices, type correspondence, etc. A firm paraprofessional will be used to foot client schedules and records, to perform clerical work for sending accounts receivable confirmations and other correspondence, and to perform certain limited account analysis work.

C. Workspace and Equipment

The client's conference room has been booked from October 1 to October 5 and from January 21 to February 14, 19Y for our use. The client will provide three calculators. We will need to bring our microcomputer and printer.

D. Assignment of Staff

Jim Bob Simmons, In-charge, and Mary Smith and John Jones, assistants, have been assigned for the dates of field work in C above. All worked on the engagement last year.

E. Target Dates

Audit report	March 1, 19Y
Management letter	March 1, 19Y
Tax returns	March 15, 19Y
Start of interim field work	October 1, 19X
Start of year-end field work	January 21, 19Y
Other	

F. Use of Specialists

We have engaged Hank Brown of Best Wood Products Co. to assist us in observation of the building materials inventory. Our firm's EDP consultant, Gene Osborne, will prepare a detailed EDP Questionnaire and assist us in designing our tests. Joe Flow, of ASC actuaries, will prepare the information necessary for the pension plan contribution and related matters.

G. Use of Audit Software

Our audit software package will be used to record the trial balance, post adjustments and generate financial statements. Analytical procedures will be performed as a by-product using that software. The time budget and control documents will also be prepared with software.

H. Audit Budget

Based on the prior year's actual time and preliminary discussions of current circumstances with client personnel, the budget is computed as follows:

	<u>Hours</u>	<u>Rate</u>	<u>Dollars</u>
Partner	10	\$ 150	\$ 1,500
Manager	40	90	3,600
In-Charge	160	50	8,000
Assistants	<u>120</u>	30	<u>3,600</u>
Total	<u>330</u>		<u>\$16,700</u>

I. Other Special Considerations

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk (See Workpaper F)

B. Understanding of the Internal Control Structure

We have completed the Internal Control Questionnaire (see Workpaper D) to obtain an understanding of the three elements of the internal control structure — the control environment, the accounting system, and control procedures.

C. Overall Materiality Limit

Because of the previously-mentioned factors, the overall materiality limit will be \$75,000 (see Workpaper G). Immaterial account balances will be so noted on the trial balance and excluded from testing.

D. Sampling

Sampling will be applied to counting, pricing, and clerically testing inventories and to confirming accounts receivable — because it is the most cost-effective way to audit these areas. Other procedures for other audit areas will be based on the examination of individually significant items.

Sampling applications:

Because of the overall engagement risk, the acceptable risk of incorrect acceptance for sampling applications will be low. Based on prior experience, the expected population error amounts are low. On the Planning Matrix, planned reliance, with the exception of sales cutoff errors discovered in controls testing, will be low for all financial statement classifications affected by controls testing. Sales cutoff tests will be expanded to compensate for errors discovered in the controls tests.

See applicable working papers documenting the selection process and sample sizes for specific sampling applications.

E. Audit Approach

Because control risk is considered slightly less than maximum, slightly less tests of balances procedures will be performed. Analytical procedures will consist primarily of corroborating procedures.

F. Key Engagement Areas

Key engagement areas, based on the risk and materiality associated with each, are:

- Inventories,
- Deferred income tax liabilities and assets,

- Related party transactions, and
- Loan covenant compliance.

G. Planning Analytical Procedures

Because extensive tests of balances were performed, analytical procedures (see Workpaper E) consisted primarily of corroborating procedures.

H. Other Special Considerations

Prepared by: _____
(In-Charge)

Date: _____

Reviewed by: _____
(Engagement Partner)

Date: _____

5.609

Altman Zeta (Z) Score Calculation Form

Client: _____

Financial Statement Date: _____

The Z Score may be used as one indicator of an entity's financial "health" and ability to continue as a going concern. It is used when the auditor becomes aware of conditions and events that raise questions about the entity's ability to continue as a going concern. If Total Z Score determined under this calculation exceeds 2.6, the entity can probably be considered sound and secure. If less than 1.1, long-range survival prospects can probably be considered dim.

The calculation presented here is a general one. Somewhat different calculations, constants, and values apply to manufacturing and service entities. In those cases, additional research should be performed. Adjust the calculations as necessary for the client's situation.

The trend of the Z Score should also be part of the analysis. If a negative trend exists, even though Z Score is in the healthy range, a problem may be developing. On the other hand, if Z Score indicates that survival prospects are not favorable, but the trend is positive, a brighter future may be in store.

This Form should be prepared by the in-charge and reviewed and approved by the engagement partner. The conclusions should be documented in the Client Acceptance and Continuance Form and in the Audit Planning Memorandum.

		Results × Constant =			Value		
					Current	Prior Years	
					Year		
					19__	19__	19__
1.	<u>Working Capital</u>	_____	×	6.56 =	_____	_____	_____
	Total Assets						
2.	<u>Retained Earnings</u>	_____	×	3.26 =	_____	_____	_____
	Total Assets						
3.	<u>Earnings Before Interest and Taxes</u>	_____	×	6.72 =	_____	_____	_____
	Total Assets						
4.	<u>Equity</u>	_____	×	1.05 =	_____	_____	_____
	Total Liabilities						
	Total Z Score				_____	_____	_____



ALTMAN ZETA (Z) SCORE CALCULATION FORM
(Continued)

Discuss and evaluate any significant factors that might mitigate a low score (for example, "large back order of business") and list any suggestions that might help entity improve its financial status:

Discuss and evaluate any significant factors (including non-financial items) that might impact upon the entity’s ability to continue as a going concern (including loss of significant customers, legal issues or management plans). If necessary, evaluate prospective financial information. Attach all items used.

Conclusion:

19____ 19____ 19____ 19____ 19____

Prepared by:

Reviewed by:

5.610

Time Summary Form

Client: _____

Financial Statement Date: _____

	Budgeted Time					Actual Time					Actual Over Under)*
	Asst.	I/C	Mngr.	Ptnr.	Total	Asst.	I/C	Mngr.	Ptnr.	Total	
Planning & administration											
Internal control structure											
Cash											
Investments											
Receivables											
Inventories											
Prepayments & other assets											
Property & equipment											
Notes & loans payable											
Payables & accruals											
Income taxes											
Other liabilities											
Equity											
Revenues											
Expenses											
Commitments, contingencies, & subsequent events											
Consideration of continued existence											
Related parties											
Trial balance & adjustments											
Supervision & review											
Report preparation											
Management letter											
TOTAL											

* Attach memorandum explaining significant variances.

5.611

Time Accumulation Sheet

Client: _____

Financial Statement Date: _____

WORK AREAS	ACTUAL TIME AND DATE												Total
	Budget	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	Sub-total	
Planning & administration	—	—	—	—	—	—	—	—	—	—	—	—	—
Internal control structure	—	—	—	—	—	—	—	—	—	—	—	—	—
Cash	—	—	—	—	—	—	—	—	—	—	—	—	—
Investments	—	—	—	—	—	—	—	—	—	—	—	—	—
Receivables	—	—	—	—	—	—	—	—	—	—	—	—	—
Inventories	—	—	—	—	—	—	—	—	—	—	—	—	—
Prepayments & other assets	—	—	—	—	—	—	—	—	—	—	—	—	—
Property & equipment	—	—	—	—	—	—	—	—	—	—	—	—	—
Notes & loans payable	—	—	—	—	—	—	—	—	—	—	—	—	—
Payables & accruals	—	—	—	—	—	—	—	—	—	—	—	—	—
Income taxes	—	—	—	—	—	—	—	—	—	—	—	—	—
Other liabilities	—	—	—	—	—	—	—	—	—	—	—	—	—
Equity	—	—	—	—	—	—	—	—	—	—	—	—	—
Revenues	—	—	—	—	—	—	—	—	—	—	—	—	—
Expenses	—	—	—	—	—	—	—	—	—	—	—	—	—
Commitments, contingencies, & subsequent events	—	—	—	—	—	—	—	—	—	—	—	—	—
Consideration of continued existence	—	—	—	—	—	—	—	—	—	—	—	—	—
Related parties	—	—	—	—	—	—	—	—	—	—	—	—	—
Trial balance & adjustments	—	—	—	—	—	—	—	—	—	—	—	—	—
Supervision & review	—	—	—	—	—	—	—	—	—	—	—	—	—
Report preparation	—	—	—	—	—	—	—	—	—	—	—	—	—
Management letter	—	—	—	—	—	—	—	—	—	—	—	—	—
TOTAL	==	==	==	==	==	==	==	==	==	==	==	==	==

5.612

Engagement Performance Review Checklist
Client: _____
Financial Statement Date: _____

INSTRUCTIONS:

This checklist documents the in-charge and engagement partner review responsibilities, as required by the firm's quality control policies and procedures.

Part I of the checklist should be completed by the in-charge at the completion of the engagement. Part II should be completed by the engagement partner.

<u>Part I</u>	<u>Yes</u>	<u>N/A</u>	<u>See Additional Comments</u>
Administrative Considerations:			
1. Have all required engagement programs, forms, and checklists been completed, signed, and dated?	_____	_____	_____
2. Have all working papers been reviewed for:			
a. Initials and dates of preparation and review.	_____	_____	_____
b. Proper format, i.e., headings, tickmark explanations, indexing, and cross-referencing.	_____	_____	_____
c. Footing and testing of schedules prepared by client.	_____	_____	_____
d. Posting of adjustments and cross-referencing to trial balance.	_____	_____	_____
e. Agreeing beginning balances to prior year's working papers.	_____	_____	_____

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST (Continued)

	<u>Yes</u>	<u>N/A</u>	<u>See Additional Comments</u>
3. Do financial statements agree with the trial balance?	_____	_____	_____
4. Has the Time Summary Form been completed, and significant variances between budget and actual been explained?	_____	_____	_____
5. Have the following letters been obtained and reviewed for proper dating and propriety?			
a. Client representation letter (dated as of the auditor's or accountant's report date).	_____	_____	_____
b. Lawyers' letters (dated within two weeks of the auditor's report date).	_____	_____	_____
Other Considerations:			
1. Have you reviewed all work done by assistants and cleared all review points?	_____	_____	_____
2. Does the work performed accomplish the objectives of the engagement?	_____	_____	_____
3. Do the conclusions in the working papers support the type of report issued?	_____	_____	_____
4. Are you satisfied there are no material errors, and no irregularities or illegal acts unless they are clearly inconsequential?	_____	_____	_____
5. Has the engagement been completed in accordance with firm policy and authoritative standards?	_____	_____	_____
6. Have all problems been adequately resolved?	_____	_____	_____
7. If a situation has been encountered that impairs the firm's independence, has a disclaimer of opinion been issued for public companies or a step-down to a compilation with lack of independence been noted for nonpublic companies?	_____	_____	_____

◆

Prepared by: _____ Date: _____
(In-Charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST (Continued)

Part II (To be completed by engagement partner)Initials

1. I have reviewed the engagement working papers, work programs, checklists, etc. to the extent required by firm policy. _____
2. I have reviewed the financial statements for appropriate form and conformity with professional standards. _____
3. I have reviewed the independent auditor's (accountant's) report for conformity with professional standards, and have determined that the conclusions reached in the working papers support our report. _____
4. I authorize issuance of the financial statements and the report. _____

Prepared by: _____ Date: _____
(In-Charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

CHAPTER 6
PROFESSIONAL DEVELOPMENT

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CHAPTER 6

PROFESSIONAL DEVELOPMENT

6.000 WHAT "PROFESSIONAL DEVELOPMENT" MEANS

6.001 One of the easiest ways for your firm to get into trouble is for it to take on an engagement that it is not qualified to handle. The first general standard of *Statement on Auditing Standards No. 1* (SAS No. 1) reads:

The audit is to be performed by a person or persons having *adequate technical training and proficiency* as an auditor. [Emphasis added.]

6.002 A firm that does one or two audits a year is unlikely to be as "adequately technically trained and proficient" as one that performs 20 a year. Training and hands-on auditing experience is necessary to meet the proficiency requirement. Thus, in the context of your quality control system, the professional development element means that you must be careful and know your limitations.

6.003 Your professional development policies and procedures must reasonably ensure that your personnel will have the knowledge necessary to fulfill the responsibilities that you assign to them. "Personnel" also includes non-CPAs.

Practice Tip:

If you are a member of the SECPS, at least 40% of annual CPE hours must be in accounting and auditing.

This is perhaps a concept that all firms that issue financial statements should follow. (See section 6.306.)

6.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

6.101 SQCS No. 1. Statements on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to professional development:

Policies and procedures for professional development should be established to provide the firm with reasonable assurance that personnel will have the knowledge required to enable them to fulfill responsibilities assigned. Continuing professional education and training activities enable a firm to provide personnel with the knowledge required to fulfill responsibilities assigned to them and to progress within the firm.

6.102 Code of Professional Conduct. The Code of Professional Conduct, ET section 56 ("Due Care"), reads as follows:

A member should observe the profession's technical and ethical standards, *strive continually to improve competence* and the quality of services, and discharge professional responsibility to the best of the member's ability. [Emphasis added]

6.103 AICPA Implementing Resolution. The members of the American Institute of Certified Public Accountants (AICPA) adopted the following bylaw with regard to continuing professional education (CPE) (Bylaw section 230 R):

For each three-year reporting period beginning with the 1989 calendar year, or with the second full calendar year after the adoption of the bylaw provision, AICPA members in public practice, except those in retirement, shall demonstrate for each calendar year that they have completed acceptable continuing education as follows:

- A. A member in public practice shall, during each three-year reporting period, complete 120 hours with a minimum of twenty hours each year.
- B. A member who complies with a state licensing or state society membership continuing education requirement shall be deemed to be in compliance with this provision, provided such a requirement is for an average of forty hours per year, at a minimum, and provided the member submits a statement of compliance with such a requirement showing completion of at least twenty hours each year.
- C. A member who is not subject to such a state requirement shall submit each year a report of the amount of continuing education completed during the immediately preceding calendar year showing for each program completed (1) the sponsoring organization, (2) the location at which the program was given, (3) the title of the program or a description of its contents, (4) the dates attended, and (5) the number of hours claimed.

Exemptions may be granted for poor health, military service, foreign residency, and similar reasons.

State Boards of Accountancy

6.104 All state boards of accountancy and state CPA societies have adopted CPE requirements for their members. For the most part, these requirements are similar to the AICPA standards in that they generally require an average of 40 CPE hours per year.

Other Regulatory Agencies

6.105 Certain other regulatory agencies (such as the U.S. General Accounting Office—GAO—in its *Government Auditing Standards*—the "yellow book") have adopted their own continuing professional development requirements to make sure practitioners remain current in the particular specialized areas under their jurisdiction. Basically, the GAO requires that 24 hours every two years be on government-related topics. Also, see Practice Tip on page 6-3.

6.200 HOW TO ADDRESS PROFESSIONAL DEVELOPMENT

6.201 Your firm needs to develop basic policies and procedures to ensure (and document) that, through its professional firm members, it meets the professional development requirements.

Basic Approach

6.202 Professional development is a requirement that individual professional members of your firm must meet. Only an individual can sit in the classroom or take a self-study course; a firm cannot.

6.203 However, it is your firm's responsibility to monitor compliance by its individual members. Your firm should also back up individual members' formal CPE efforts with appropriate in-house actions, such as distribution of authoritative pronouncements and on-the-job training.

Appoint Someone in Your Firm to Monitor Compliance

6.204 Someone in the firm, such as the managing partner (or quality control partner or proprietor) should be responsible for making sure the firm's professional members each attain the necessary CPE hours.

Know How and When to Monitor

6.205 Your firm should probably monitor compliance at least twice during a reporting year:

1. It should consider sending a notice to each appropriate professional firm member before the end of the reporting period advising that the reporting period is about to end, stating how many CPE hours the firm's records reflect for the individual and, if he or she has not completed the necessary CPE hours, advising the individual to begin to meet the objectives immediately.

Practice Tip:

To ensure that firm members have time to complete their CPE obligations, this notice should probably be sent at least two months *before* the end of the reporting period.

2. Approximately a week or so after the end of the reporting period, the firm should obtain official documentation from all professional firm members in which they indicate and confirm that they have, indeed, attended courses for the necessary number of hours (see sections 6.603 and 6.604 for sample forms). *Your firm should retain this documentation.*

Distribute Appropriate New Pronouncements

6.206 As part of your compliance with the consultation element, someone in your firm has to have responsibility for obtaining and distributing new professional pronouncements to appropriate firm members (section 4.311). You should view this responsibility as part of your professional development effort as well.

Remember On-the-Job Training

6.207 As discussed further in the context of supervision, assigning personnel to engagements, and advancement (see Chapters 5, 9, and 10, respectively), on-the-job training is an important part of the professional development process.

6.208 In assigning personnel to individual engagements, you should take into account their prior experience and their need for supervision, additional experience, and training in various accounting and auditing aspects. In addition, your firm should monitor their learning and progress on the jobs through sufficient and timely supervision of their work.

6.300 SOME TIPS AND TECHNIQUES

Identify and Evaluate Possible CPE Sources

6.301 Local CPA firms rely overwhelmingly on out-of-house CPE programs. Members of these firms attend courses or pursue self-study courses prepared and presented by the AICPA, state societies, and independent training companies, among others. However, you should be aware of the pluses and minuses of outside courses, as well as of the in-house options available to you.

Outside Courses

6.302 These courses adhere to professional standards and are well done. They generally offer excellent workbooks and handout materials, are carefully structured, and are presented by well-trained and experienced personnel. However, they can be relatively expensive on a per contact hour basis, and they may not be specifically targeted to *your* practice.

In-House Resources

6.303 It is really not as difficult as you might expect for local firms to put together, and present, their own in-house CPE programs. You might also join with other firms to present a CPE program. Your firm—like every firm—has experts of some type. These experts are capable of discoursing on a particular topic, and can pass their knowledge on to others.

Practice Tip:

One of the best ways for your firm to become involved with in-house presentations is to have one of its members attend an outside presentation and then come back and give an in-house presentation on the topic. In this way, the presenter will get a feel for what should be covered, how best to cover it, how to relate to the audience, and so forth.

6.304 It goes without saying that the major advantages of in-house CPE presentations are greatly reduced cost per contact hour and a more personal approach.

Practice Tip:

Remember that if you attempt to set up in-house CPE training programs, you must comply with the AICPA's explicit standards for CPE course development, presentation, and evaluation, as well as those of your own state.

Have Your CPE Reflect Your Practice

6.305 It is important to make sure that the CPE programs your firm members attend meet the needs of the entire spectrum of your firm's practice. If your firm has a mixture of an accounting or auditing practice and a tax practice, its CPE programs should not all be concentrated in the tax area with the accounting or auditing areas ignored.

6.306 Actual peer reviews have found tax concentration (and exclusion of accounting and auditing topics) to be a problem for many local firms.

Practice Tip:

Make sure your professional firm members receive well-rounded training and CPE contact in *all* necessary topics.

Also, make sure some of the CPE programs your firm members attend relate to your firm's particular area of specialty. If, for example, your clientele consists heavily of construction contractors, make sure a portion of your CPE programs are in areas of accounting and auditing for construction contractors.

Finally, make sure some of the CPE programs also cover newly issued accounting and auditing pronouncements that affect your practice.

State Requirements

6.307 Some states specifically require that a portion of CPE hours be devoted to accounting and auditing topics. You should stay abreast of your own state's actual requirements.

Decide Whom to Cover

6.308 Unless your firm is a member of the AICPA's Division for Firms, the AICPA's CPE requirements apply only to the persons in your firm who are AICPA members. (Basically, to be an AICPA member, you must be certified.) Your firm must decide whether it wants its CPE requirements to apply to your professional staff who are not AICPA members, such as new staff members who have not yet completed the CPA exam and paraprofessionals. (The Division for Firms' CPE requirements are more stringent and apply to *all* professional firm members.)

6.309 Unfortunately, you cannot make your decision about noncertified members lightly. If you rely on outside CPE resources, it might be rather costly for you to make them available to noncertified firm members.

6.310 On the other hand, the benefits of having well-trained staff are self-evident—and what professional development is all about. If your noncertified staff are involved in the preparation of financial statements, they probably should be included in your CPE coverage.

Know When You Need Help

6.311 If your firm lacks the necessary experience or knowledge to perform a particular assignment, it has three options: (1) obtain the knowledge through CPE or consultations, (2) hire someone who has the experience or knowledge on a contract or hourly basis, or (3) decline the engagement. Most firms will find it easiest to adopt the second option.

6.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE PROFESSIONAL DEVELOPMENT ELEMENT

6.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire: (See section 2.700 in Chapter 2.)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of specific procedures and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Has established appropriate continuing professional education requirements for personnel at each level within the firm?

- Adequately monitors development of continuing professional education programs, maintains appropriate records, and monitors the records?
- Provides personnel with appropriate professional literature relating to current developments on a timely basis?
- Provides personnel with appropriate programs including, to the extent necessary, programs to fill the firm's needs for personnel with expertise in specialized areas and industries?
- Provides adequate on-the-job training?
- Adequately communicates its policies and procedures relating to continuing professional education to all professional personnel?
- Complied with its policies and procedures relating to professional development during the period and adequately documented its compliance to the extent required by firm policy?

6.500 SAMPLE POLICIES AND PROCEDURES

6.501 With regard to the professional development element, *all* firms, regardless of their size, need to adopt certain *theories* behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. Some portions are *not* necessary for smaller firms that do not conduct in-house programs. The AICPA sample appears in section 6.502. Alternative, simpler wording for smaller firms is provided in section 6.503.

AICPA Sample System

6.502 The AICPA's suggested sample policies (in *italics*) and procedures on professional development read:

1. *Establish guidelines and requirements for the firm's professional development program and communicate them to personnel.*
 - a. Assign responsibility for the professional development function to a person or group with appropriate authority.
 - b. Provide that programs developed by the firm be reviewed by qualified individuals. Programs should contain statements of objectives and education and/or experience prerequisites.
 - c. Provide an orientation program relating to the firm and the profession for newly employed personnel.
 - (i) Prepare publications and programs designed to inform newly employed personnel of their professional responsibilities and opportunities.

-
- (ii) Designate responsibility for conducting orientation conferences to explain professional responsibilities and firm policies.
 - (iii) Enable newly employed personnel with limited experience to attend the AICPA or other comparable-level staff training programs.
 - d. Establish continuing professional education requirements for personnel at each level within the firm.
 - (i) Consider state mandatory requirements or voluntary guidelines in establishing firm requirements.
 - (ii) Encourage participation in external continuing professional education programs, including college-level and self-study courses.
 - (iii) Encourage membership in professional organizations. Consider having the firm pay or contribute toward membership dues and expenses.
 - (iv) Encourage personnel to serve on professional committees, prepare articles, and participate in other professional activities.
 - e. Monitor continuing professional education programs and maintain appropriate records, on both a firm and an individual basis.
 - (i) Review periodically the records of participation by personnel to determine compliance with firm requirements.
 - (ii) Review periodically evaluation reports and other records prepared for continuing education programs to evaluate whether the programs are being presented effectively and are accomplishing firm objectives. Consider the need for new programs and for revision or elimination of ineffective programs.
 - 2. *Make available to personnel information about current developments in professional technical standards and materials containing the firm's technical policies and procedures and encourage personnel to engage in self-development activities.*
 - a. Provide personnel with professional literature relating to current developments in professional technical standards.
 - (i) Distribute to personnel material of general interest, such as pronouncements of the Financial Accounting Standards Board and the AICPA Auditing Standards Board.
 - (ii) Distribute pronouncements in areas of specific interest, such as those issued by the Securities and Exchange Commission, Internal Revenue Service, and other regulatory agencies to persons who have responsibility in such areas.

- (iii) Distribute manuals containing firm policies and procedures on technical matters to personnel. Manuals should be updated for new developments and changing conditions.
- b. For training programs presented by the firm, develop or obtain course materials and select and train instructors.
 - (i) State the program objectives and education and/or experience prerequisites in the training programs.
 - (ii) Provide that program instructors be qualified in both program content and teaching methods.
 - (iii) Have participants evaluate program content and instructors of training sessions.
 - (iv) Have instructors evaluate program content and participants in training sessions.
 - (v) Update programs as needed in light of new developments, changing conditions, and evaluation reports.
- 3. *Provide, to the extent necessary, programs to fill the firm's needs for personnel with expertise in specialized areas and industries.*
 - a. Conduct firm programs to develop and maintain expertise in specialized areas and industries, such as regulated industries, computer auditing, and statistical sampling methods.
 - b. Encourage attendance at external education programs, meetings, and conferences to acquire technical or industry expertise.
 - c. Encourage membership and participation in organizations concerned with specialized areas and industries.
 - d. Provide technical literature relating to specialized areas and industries.
- 4. *Provide for on-the-job training during the performance of engagements.*
 - a. Emphasize the importance of on-the-job training as a significant part of an individual's development.
 - (i) Discuss with assistants the relationship of the work they are performing to the engagement as a whole.
 - (ii) Involve assistants in as many portions of the engagement as practicable.
 - b. Emphasize the significance of personnel management skills and include coverage of these subjects in firm training programs.

-
- c. Encourage personnel to train and develop subordinates.
 - d. Monitor assignments to determine that personnel—
 - (i) Fulfill, where applicable, the experience requirements of the state board of accountancy.
 - (ii) Gain experience in various areas of engagements and varied industries.
 - (iii) Work under different supervisory personnel.

Alternative Sample System

6.503 The following sample system (in *italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

6.504 *It is our firm's policy that its (certified) professional personnel each obtain necessary continuing professional education contact hours of a minimum average of 40 hours per year so as to enable them to continue to maintain and update their professional skills, as well as meet the requirements of our state.*

The procedures listed below are to be followed with regard to this policy:

1. The firm's managing partner (or quality control partner or proprietor) is responsible for monitoring firm members' compliance with this policy and for determining which programs qualify with regard to each individual firm member.
2. The firm's managing partner (or quality control partner or proprietor) is responsible for monitoring the assignment of personnel to engagements in order to expose the personnel to as many facets of accounting and auditing matters as possible through on-the-job training.
3. The firm's managing partner (or quality control partner or proprietor) is responsible for distributing to appropriate personnel newly issued pronouncements from the AICPA, FASB, GASB, and so forth that impact on the operation of our practice.
4. The firm's managing partner (or quality control partner or proprietor) is responsible for ensuring that firm-sponsored programs comply with our state's requirements.

6.600 SAMPLE DOCUMENTATION

6.601 At a minimum, you must document that your firm has complied with its policies and procedures and that all personnel have complied with applicable state CPE requirements. If applicable, you must also document that your firm has complied with Private Companies Practice Section (PCPS) or SEC Practice Section (SECPS) or GAO CPE requirements. To do this, you should:

1. Obtain annual CPE course attendance records or confirmation from each staff member subject to your CPE policy, *and*
2. Obtain or compile annual information on each staff member's CPE records.

6.602 If you conduct in-house CPE, you should collect and maintain evaluations. You also must obtain and keep on file course outlines. For the specific CPE requirements in your state, contact your state board.

6.603 CPE Course Attendance Documentation**CONTINUING PROFESSIONAL EDUCATION CREDIT FORM**

NOTE: AT THE END OF THE PROGRAM, COMPLETE THIS FORM AND TURN IN THE TOP COPY. RETAIN BOTTOM COPY FOR YOUR RECORDS.

SPONSOR:
PROGRAM:
DATES:
LOCATION:

PARTICIPANT: _____

FIRM/AFFILIATION: _____

ADDRESS: _____

CITY: _____ STATE: _____ ZIP CODE: _____

CPA CERTIFICATE # _____

PLEASE CIRCLE MINUTES ATTENDED

DATE:	ACCOUNTING/ AUDITING	TAX	OTHER

MINUTES ATTENDED: TOTALS

Total Accounting/Auditing _____

Total Tax _____

Total Other _____

Total Combined _____

CPE Credit Hours: _____

Grand Total Minutes/50 _____

(MAXIMUM RECOMMENDED CPE CREDIT HOURS =)
 I CERTIFY THAT I ATTENDED THE SESSION CIRCLED ABOVE.

SIGNATURE: _____

FIRM COPY — WHITE

PARTICIPANT'S COPY — CANARY

6.604 Individual CPE Record

INDIVIDUAL CPE RECORD				
Reporting Period Ended: _____				
Program Sponsor	Sponsor ID #	Program Title or Description	Date(s) Completed	CPE Hours
Total				

Name: _____ AICPA Member #: _____

Firm: _____ Date Joined AICPA: _____

CPA Certificate(s): _____

State: _____ Certificate #: _____

State: _____ Certificate #: _____

TOTAL CPE HOURS	
Year 1	
Year 2	
Year 3	
Total	

Note: Some states also require disclosure of course numbers.

6.605 In-House CPE Evaluation (to be completed by the participant)

Course Title: _____
 Course Number: _____
 Course Date(s): _____
 Instructor(s): _____
 Participant's Name: _____

	<u>Outstanding</u>	<u>Above Average</u>	<u>Average</u>	<u>Below Average</u>	<u>Poor</u>
Objectives met	_____	_____	_____	_____	_____
Instructor effectiveness	_____	_____	_____	_____	_____
Advance preparation materials	_____	_____	_____	_____	_____
Program content—timeliness and effectiveness	_____	_____	_____	_____	_____
Facilities	_____	_____	_____	_____	_____
Prerequisites appropriate	_____	_____	_____	_____	_____

Comments: _____

CHAPTER 7
ACCEPTANCE AND CONTINUANCE OF CLIENTS

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CHAPTER 7

ACCEPTANCE AND CONTINUANCE OF CLIENTS

7.000 WHAT "ACCEPTANCE AND CONTINUANCE" MEANS

7.001 You must investigate clients, initially and on an on-going basis, to minimize the likelihood of associating with a client whose management or ownership lacks integrity.

7.002 As part of your quality control system, you must establish policies and procedures that reasonably ensure that the clients for which you perform financial statement engagements possess the requisite management integrity.

7.003 You must also be careful about accepting high-risk clients, such as financial institutions, municipalities, oil and gas companies, companies in high technology industries, and broker/dealers.

Practice Tip:

Acceptance and continuance of clients is an area where documentation by local firms has often been lax. Quite often, in today's highly competitive environment, the typical local firm's entire acceptance procedure has consisted of answering *one* question: "How large is the fee?" However, you *must* go beyond that simple question to determine the *character* of the persons associated with the client with which you are becoming involved. These important, required procedures should *not* just be viewed as a practice development exercise! You must protect yourself.

Practice Tip:

This chapter begins the discussion of the elements that ordinarily will *not* be formally stressed during the peer review process for firms with 10 or fewer professionals and no SEC clients. But those firms should not be lulled into a false sense of security. Their peer reviewers *will* look at those elements if they believe that there is a reason to do so. Thus, firms must realize that they should comply with quality control standards for all elements, and have the necessary documentation in their files.

7.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA SQCS No. 1

7.101 Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to acceptance and continuance of clients:

Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity. Suggesting that there should be procedures for this purpose does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its professional relationships.

Practice Tip:

Although SQCS No. 1 was issued in 1979, documentation of the investigatory procedures relating to acceptance and continuance is probably missing from the files of many local practitioners.

7.200 HOW TO ADDRESS ACCEPTANCE AND CONTINUANCE

7.201 Your firm needs to develop some basic policies and procedures to ensure (and document) both an appropriate investigation before accepting new clients and a similar review of existing clients.

Practice Tip:

Although this element applies only to your financial statement clients, consider also applying it to your tax clients.

Basic Approach

7.202 In addressing acceptance and continuance, you should collect and evaluate facts about your potential and existing clients.

Collect and Evaluate the Facts

7.203 Your firm must ensure that it is not embarking upon or continuing relationships with a client whose ownership and/or management has demonstrated that it lacks integrity, has unrealistic expectations of you, or otherwise makes you uncomfortable about continuing representation—for example, because of its industry, financial condition, or litigation status.

7.204 The simplest approach for a local firm to take is to complete certain forms during the investigatory process with regard to new financial statement clients and annually with regard to all existing financial statement clients.

Practice Tip:

Although generally accepted auditing standards do not *require* their use, engagement letters are an important tool in establishing and documenting your understanding with your clients about precisely what your responsibilities are in performing work for them. Most insurance carriers now also offer premium savings to firms that use engagement letters.

7.300 SOME TIPS AND TECHNIQUES

Communicate With Your Predecessor

7.301 Keep in mind that two separate and distinct stages of communications should occur between you and your predecessors:

1. Pre-acceptance *and*
2. Post-acceptance.

Practice Tip:

Most local practitioners have been complying with stage two. You must make sure that you also comply with (and document) the *first*.

7.302 Although the requirement to communicate with the predecessor applies only to audit engagements, it is a good idea on compilation and review engagements as well.

Pre-Acceptance

7.303 Before you accept an engagement, you should ask your predecessor if there are any reasons why you should decline it (such as questions about management's integrity or unreasonable expectations of the accountants, disputes about treatment of items in the financial statements, and the like).

Practice Tip:

One of your most important overall objectives is to learn of bad situations *before* you read negative mentions of your client's name in the newspapers or receive a subpoena. Short of that, inquiring about your prospective clients protects your bottom line.

You should *disassociate* yourself as expeditiously as possible from a client (or potential client) if you have a serious concern about the attitude, ability, reputation, or integrity of its management or ownership.

The pre-acceptance stage should not be overlooked on *nonaudit* engagements. One local firm lost more than \$70,000 on a nonaudit engagement because it failed to ask the proper questions before it accepted a client, only to learn, after the work was complete, that the client had a history of nonpayment.

Post-Acceptance

7.304 After acceptance, you should review your predecessor's engagement files—to see if you can rely upon the predecessor's work and if there is anything that can benefit you.

Consider Continuance of Existing Clients

7.305 You need to reconsider relationships with existing clients on a regular basis so your firm can ensure that it is not continuing a relationship with a client whose ownership or management has demonstrated that it lacks integrity, has unrealistic expectations of you, or otherwise makes you uncomfortable about continuing representation.

Practice Tip:

One relatively painless method of documentation for existing clients is to put a step in your work programs (both for audits and for unaudited engagements such as compilations and reviews) that allows you to sign off regarding client acceptance or continuance factors. Some firms also document partners' discussions about clients in the firm's minutes.

Approve Work in Advance

7.306 The individual in your firm, such as the managing partner (or quality control partner or proprietor), who is responsible for your quality control system should ensure that the firm complies as appropriate with the procedures outlined above and that *no* work is performed for any client without prior approval.

7.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE ACCEPTANCE AND CONTINUANCE ELEMENT

7.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on AICPA questionnaire: (See section 2.700 in Chapter 2)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm, and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Has established appropriate policies and procedures for evaluating and obtaining information about prospective clients?
- Requires communication with predecessor auditors, if any, in accordance with auditing standards?
- Has established appropriate policies and procedures for evaluating whether the relationship with existing clients should be continued?
- Communicates its policies and procedures for accepting and continuing clients to appropriate personnel?
- Adequately monitors its compliance with its policies and procedures relating to acceptance and continuance of clients?
- Complied with its policies and procedures relating to acceptance and continuance of clients during the period and adequately documents its compliance to the extent required by firm policy?

7.500 SAMPLE POLICIES AND PROCEDURES

7.501 With regard to the acceptance and continuance element, all firms, regardless of their size, need to adopt the theories behind, but not necessarily the exact wording of, the American Institute of Certified Public Accountants' (AICPA's) suggested sample policies and procedures. The AICPA sample appears below. Alternative, simpler wording is provided in sections 7.503–7.504.

AICPA Sample System

7.502 The AICPA's suggested sample policies (in *italics*) and procedures on acceptance and continuance read as follows:



1. *Establish procedures for evaluation of prospective clients and for their approval as clients.*
 - a. Consider evaluation procedures such as the following before accepting a client:
 - (i) Obtain and review available financial information regarding the prospective client, such as annual reports, interim financial statements, registration statements, Form 10-K, other reports to regulatory agencies, and income tax returns.
 - (ii) Inquire of third parties about any information regarding the prospective client and its management and principals that may have a bearing on evaluating the prospective client. Inquiries may be directed to the prospective client's bankers, legal counsel, investment banker, underwriter, and others in the financial or business community who may have such knowledge. Credit reports may also be useful.
 - (iii) Communicate with the predecessor auditor as required by auditing standards. Inquiries should include questions regarding facts that might bear on the integrity of management, on disagreements with management regarding accounting principles, auditing procedures, or other similarly significant matters, and on the predecessor's understanding of the reasons for the change of auditors.
 - (iv) Consider circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks.
 - (v) Evaluate the firm's independence and ability to service the prospective client. In evaluating the firm's ability, consider needs for technical skills, knowledge of the industry, and personnel.
 - (vi) Determine that acceptance of the client would not violate applicable regulatory agency requirements and the codes of professional conduct of the AICPA or a state CPA society.
 - b. Designate an individual or group, at appropriate management levels, to evaluate the information obtained regarding the prospective client and to make the acceptance decision.
 - (i) Consider types of engagements that the firm would not accept or that would be accepted only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
 - c. Inform appropriate personnel of the firm's policies and procedures for accepting clients.
 - d. Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for acceptance of clients.

2. *Evaluate clients at the end of specific periods or upon the occurrence of specified events to determine whether the relationships should be continued.*
- a. Specify conditions that require evaluation of a client to determine whether the relationship should be continued. Conditions could include —
 - (i) Expiration of a time period.
 - (ii) Significant change since the last evaluation, including a major change in one or more of the following:
 - (a) Management.
 - (b) Directors.
 - (c) Ownership.
 - (d) Legal counsel.
 - (e) Financial condition.
 - (f) Litigation status.
 - (g) Nature of the client's business.
 - (h) Scope of the engagement.
 - (iii) The existence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.
 - b. Designate an individual or group, at appropriate management levels, to evaluate the information obtained and to make continuance decisions.
 - (i) Consider types of engagements that the firm would not continue or that would be continued only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
 - c. Inform appropriate personnel of the firm's policies and procedures for continuing clients.
 - d. Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for continuance of clients.

Alternative Sample System

7.503 The following sample system (in *italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

7.504 *It is our firm's policy that its (financial statement) clientele that meet certain conditions (set forth in our Client Acceptance and Continuance Form) are to be subject to appropriate investigatory procedures before they are accepted as clients and annually thereafter.*

The procedures listed below are to be followed with regard to this policy:

1. For all prospective financial statement clients, a Client Acceptance and Continuance Form is to be completed and submitted to the managing partner (or quality control partner or proprietor) for consideration and decision *before* work starts for the client.
2. Similar procedures are to be followed, on an annual basis, for *existing* clients.
3. Existing clients will also be re-evaluated on an interim basis should anything come to our attention that causes us to question the integrity or attitude of ownership or management.

7.600 SAMPLE DOCUMENTATION

Client Acceptance and Continuance Form

7.601 The Client Acceptance and Continuance Form (section 7.602) is designed to help firms evaluate prospective clients and to reevaluate existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients.

7.602

Client Acceptance and Continuance Form — Part I
Client: _____
Financial Statement Date: _____

INSTRUCTIONS:

Part I: Part I of this form should be completed for all prospective clients for which audit, review, or compilation services are to be performed. The form should be completed by the in-charge and approved by the engagement partner as a basis for initially accepting the client. Part I should be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II of this form should be completed by the engagement partner and concurring partner to document the firm's decision to either accept or reject the client.

CLIENT'S LEGAL NAME:	
ADDRESS:	
PHONE:	
FEDERAL I.D. NO.:	STATE I.D. NO.:

1. Describe the nature of the client's business (and locations, if other than above address):

2. Circle the type of entity (corporation, S corporation, proprietorship, LLC, or partnership)

CLIENT ACCEPTANCE AND CONTINUANCE FORM — Part I
(Continued)

3. List key owners, officers, and directors of the client:

Name	% Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Phone:
Contact person:

6. Indicate the results of our inquiries of the predecessor accountants regarding the following:

- a. Reasons for change of accountants: _____

- b. Integrity of management and owners: _____

CLIENT ACCEPTANCE AND CONTINUANCE FORM — Part I
(Continued)

c. Disagreements on accounting principles and auditing, review, or compilation procedures: _____

d. Fee disputes: _____

7. Describe the client's relationships with financial institutions: _____

Institution	Type of A/C's or Loans	Account Executive & Phone

Results of inquiries: _____

8. Describe the services to be provided by us: _____

Service	How Often?			Report Deadlines
	Monthly	Quarterly	Annually	

9. Will the financial statements and reports be used for high-risk purposes, e.g., reports to regulatory agencies, to obtain or renew significant amounts of credit, or performance bonding, or for sale of the business? If so, describe: _____

CLIENT ACCEPTANCE AND CONTINUANCE FORM — Part I
(Continued)

10. Read the latest financial statements and tax returns and indicate findings:

Item Reviewed	As of	Findings

11. Does the client have potential going-concern problems? If so, describe them: _____

12. Identify the client's legal counsel:

Name:
Address:
Phone:
Contact person:

Results of inquiries: _____

13. State name(s) of other third parties contacted and results thereof concerning management's and owners' reputation, attitude, ability, and integrity:

CLIENT ACCEPTANCE AND CONTINUANCE FORM — Part I
(Continued)

14. Describe any significant engagement performance, accounting or tax problems with which we should be concerned:

15. Describe any pending litigation against the client or its principals:

16. Describe the fee/billing arrangements:

17. Describe any potential independence problems with respect to the client:

18. Describe any major changes in the above information since our last evaluation of this client. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client:



CLIENT ACCEPTANCE AND CONTINUANCE FORM — Part I
(Continued)

	19____	19____	19____	19____	19____
Prepared or updated by:					
In-charge	_____	_____	_____	_____	_____
Reviewed by:					
Engagement Partner	_____	_____	_____	_____	_____

Client Acceptance and Continuance Form — Part II

Client: _____

Financial Statement Date: _____

- | | Yes | No |
|--|--------------------------|--------------------------|
| 1. Is there any reason to doubt the integrity of management or owners? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are we aware of any significant disagreements between management or owners and the predecessor accountant? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Does there appear to be any potential fee collection problems? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Are the client's needs beyond our capabilities or staffing abilities? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are we aware of any independence problems that may affect our ability to meet the client's needs? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are there high-risk factors related to the engagement that may affect our decision to accept the client? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Is there a potential problem with management or owners not fully understanding the limitations of the services to be provided (for example, management's expectation that we will be responsible for the detection of fraud)? | <input type="checkbox"/> | <input type="checkbox"/> |

For any "Yes" answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, using outside consultants, obtaining a retainer from the client, etc.):

Acceptance Decision:

Yes _____ No _____

Engagement Partner: _____ Date: _____

Concurring Partner: _____ Date: _____

CHAPTER 8

HIRING

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CHAPTER 8

HIRING

8.000 WHAT "HIRING" MEANS

8.001 It is sometimes difficult for a firm to find good people, a fact that makes it even more important to check out each job candidate closely. Your hiring policies and procedures must reasonably ensure that you only employ professional personnel who possess the skills and characteristics that enable them to perform their duties competently. You should analyze resumes, obtain college transcripts, contact references, and, very important, be sure to document your investigation and your decisions.

Practice Tip:

Hiring is an element with which all firms must comply. However, the peer review process will stress it for firms of more than 10 professionals only.

8.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA SQCS No. 1

8.101 Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and with which you must document compliance, in regard to hiring:

Policies and procedures for hiring should be established to provide the firm with reasonable assurance that those employed possess the appropriate characteristics to enable them to perform competently. The quality of a firm's work ultimately depends on the integrity, competence, and motivation of personnel who perform and supervise the work. Thus, a firm's recruiting programs are factors in maintaining such quality.

8.200 HOW TO ADDRESS HIRING

8.201 To satisfy this element of quality control, you must thoroughly check out the qualifications — education, background, credentials, references, and so forth — of each professional staff member that you hire. You must also *document* your compliance in each individual's personnel file.

Basic Approach

8.202 Basically, to comply with the hiring element, and to document compliance adequately, you must have good personnel files that show how you checked out your candidates. The files should include an application, a resume, or a similar document (see section 8.603).

8.203 You should keep additional documents as well:

- Candidate evaluations (section 8.604);
- College transcripts, particularly for entry-level positions;
- Evidence of reference checks, particularly of inquiries made to other employers (section 8.605); *and*
- Evidence of certification, if applicable.

8.204 Your file should also show evidence of proper new employee orientation.

Practice Tip:

All employers (not just CPA firms) must meet certain governmental requirements with regard to hiring. These requirements include items such as payroll tax withholding, minimum wage laws, occupational health and safety requirements, equal employment laws, and immigration laws. However, compliance with these requirements is not evaluated during peer reviews.

8.300 SOME TIPS AND TECHNIQUES

Identify Hiring Needs

8.301 Unfortunately, many local firms hire on a crisis basis instead of identifying their need for qualified personnel up front, well *before* the need arises. You should attempt to plan so that you will have adequate time to place the necessary advertisements, interview the applicants, make the background checks, evaluate, and so forth.

Practice Tip:

Regarding entry-level personnel who are just graduating from college, the more you prepare in advance, the better. Some top prospects make their employment decisions six months to a year before they graduate. Accordingly, if you wait until the last minute, and only begin to address your entry-level needs a month or so before they arise, you will not even have an opportunity to talk to the most qualified individuals.

Identify Staffing Sources

8.302 Because of the expense and time involved in on-campus recruiting, training of new people, and so forth, many firms hire only experienced individuals who have already worked at other firms.

8.303 There is nothing wrong with this approach. However, you should specifically recognize it as part of your policy by stating, somewhere in your documentation, that you normally hire only experienced personnel.

Practice Tip:

If you hire experienced personnel, you must make sure that the people you hire can, in fact, complete the tasks that you give them and have been adequately trained. You must supervise their work closely until you are satisfied that they can live up to your expectations. (For discussions that will assist you in these efforts, see Chapter 9 on assigning personnel to engagements and Chapter 10 on advancement.)

Establish Qualifications for Entry-Level Hirees

8.304 Although national firms attempt to hire the top 10% or so of college graduates, smaller firms sometimes hope that they are not hiring the *bottom* 10%! Accordingly, you should establish goals and objectives that ensure that you are speaking to, and hiring, the right people. A reasonable objective for a smaller firm might be to hire those who graduate in the top *one-half* of their college classes, possess good interpersonal skills, and are of good character.

Set and Monitor Guidelines for Paperwork to Be Completed

8.305 Certain important items should be in your personnel files (see the list in section 8.203). It is incumbent that someone in your firm, such as the managing partner (or quality control partner or proprietor), make sure that each file *is* complete and contains all of the necessary documentation.

Evaluate Each Candidate Carefully

8.306 You must carefully evaluate each potential hiree before you make your decision about whom to hire, the level at which to hire, and compensation. Factors to consider include self-presentation, work experience, and education. In addition, you must give particularly careful consideration to certain potential hirees, such as relatives of personnel or clients, former client employees, and the like.

Practice Tip:

Make sure you avoid potential conflicts of interest and other independence problems (see Chapter 3).

8.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE HIRING ELEMENT

8.401 At the conclusion of their work, your AICPA peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire. (See section 2.700 in Chapter 2)

Based on reading the relevant section in the quality control document and other relevant written firm materials, or the information obtained from the questionnaire filled out by the reviewed firm, discussions with firm personnel, and the results of specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Adequately plans for the firm's personnel needs and establishes appropriate hiring objectives, based on current clientele, anticipated growth, personnel turnover, etc.?
- Identifies relevant attributes, achievements, and experience to be sought in hirees?
- Appropriately investigates and evaluates the qualifications of prospective employees to assure that they meet the firm's requirements and standards?
- Adequately communicates its policies and procedures relating to hiring to those persons involved in the hiring process?
- Adequately monitors the effectiveness of its recruiting program?
- Informs new personnel of the firm's policies and procedures on a timely basis?
- Complied with its policies and procedures relating to hiring during the period and adequately documented its compliance to the extent required by firm policy?

8.500 SAMPLE POLICIES AND PROCEDURES

8.501 With regard to the hiring element, all firms, regardless of their size, need to adopt certain theories behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. However, some policies and procedures are not necessary for smaller firms that hire only occasionally. The AICPA sample appears below. Alternative, simpler wording for local firms is provided in sections 8.503–8.504.

AICPA Sample System

8.502 The AICPA's suggested sample policies (in *italics*) and procedures on hiring read as follows:

1. *Maintain a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.*

- a. Plan for the firm's personnel needs at all levels and establish quantified hiring objectives based on current clientele, anticipated growth, personnel turnover, individual advancement, and retirement.
 - b. Design a program to achieve hiring objectives which provides for —
 - (i) Identification of sources of potential hirees.
 - (ii) Methods of contact with potential hirees.
 - (iii) Methods of specific identification of potential hirees.
 - (iv) Methods of attracting potential hirees and informing them about the firm.
 - (v) Methods of evaluating and selecting potential hirees for extension of employment offers.
 - c. Inform those persons involved in hiring about the firm's personnel needs and hiring objectives.
 - d. Assign to authorized persons the responsibility for employment decisions.
 - e. Monitor the effectiveness of the recruiting program.
 - (i) Evaluate the recruiting program periodically to determine whether policies and procedures for obtaining qualified personnel are being observed.
 - (ii) Review hiring results periodically to determine whether goals and personnel needs are being achieved.
2. *Establish qualifications and guidelines for evaluating potential hirees at each professional level.*
- a. Identify the attributes to be sought in hirees, such as intelligence, integrity, honesty, motivation, and aptitude for the profession.
 - b. Identify achievements and experiences desirable for entry-level and experienced personnel; for example —
 - (i) Academic background.
 - (ii) Personal achievements.
 - (iii) Work experience.
 - (iv) Personal interests.

- c. Set guidelines to be followed when hiring individuals in atypical situations, such as —
 - (i) Hiring relatives of personnel or relatives of clients.
 - (ii) Rehiring former employees.
 - (iii) Hiring client employees.
 - d. Obtain background information and documentation of qualifications of applicants by appropriate means, such as —
 - (i) Resumes.
 - (ii) Application forms.
 - (iii) Interviews.
 - (iv) College transcripts.
 - (v) Personal references.
 - (vi) Former employment references.
 - e. Evaluate the qualifications of new personnel, including those personnel obtained from other than the usual hiring channels (for example, those joining the firm at supervisory levels or through merger or acquisition), to determine that they meet the firm's requirements and standards.
3. *Inform applicants and new personnel of the firm's policies and procedures relevant to them.*
- a. Use a brochure or another means to so inform applicants and new personnel.
 - b. Prepare and maintain a manual describing policies and procedures for distribution to personnel.
 - c. Conduct an orientation program for new personnel.

Alternative Sample System

8.503 The following policy (in *italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

8.504 *It is our firm's policy that its potential employees meet certain criteria. Potential employees must:*

- *Have graduated from a college program that enables them to sit for the CPA exam,*

- *Have graduated in the top one-half of their class, and*
- *Be able to work closely with others.*

The procedures listed below are to be followed with regard to this policy:

Employee files for newly hired personnel should, at a minimum, contain the following:

- Resume or employment application;
- Interview evaluation;
- College transcript (mandatory for entry level but optional for all others);
- Past employment verification;
- Reference verifications; *and*
- Evidence of certification, if applicable.

8.600 SAMPLE DOCUMENTATION

8.601 At a minimum, your personnel files should contain as documentation an application, a resume, or a similar document. You should keep additional documents as well:

- Candidate evaluations;
- College transcripts, particularly for entry-level positions;
- Evidence of reference checks, particularly of inquiries made to former employers; *and*
- Evidence of certification (if applicable).

You should also keep evidence of proper new employee orientation.

8.602 The following documentation should be used in the hiring process:

- Employment Application (section 8.603),
- Candidate Evaluation Form (section 8.604), *and*
- Record of Reference Check (section 8.605).

8.603 EMPLOYMENT APPLICATION

Federal and state laws prohibit discrimination in employment practices on account of race, creed, color, national origin, ancestry, sex, age, marital status, veteran status, or handicap.

Last Name, First Name, MI

Date

Is any additional information relative to change of name or nickname necessary to enable to check on your work record? Explain.

Present Address (include Street, City, State, and Zip Code)

Phone

Last Previous Address (if at present address less than two years)

Are you legally employable within the United States at the present time?

Have you ever been convicted of a crime? Give details.

Have you ever applied to this organization for a job before? If yes, when?

What brought you to this organization?

☐ newspaper ad ☐ friend/employee

☐ employment agency ☐ on my own

☐ school ☐ other source

☐ state employ. service

Were you ever employed by this organization?

Position Desired:

Minimum Salary Desired: \$

Status (circle one): full/part-time/summer

Earliest start date:

Work Experience — account for all employment since high school or last ten years, whichever is less, with most recent experience first.

From Mo./Yr.	To Mo./Yr.	Employer Name, Address	Principal Duties	Salary		Supervisor's Name, Title, #	Reason for lvg.
Beg.	End						

Account for all unemployment since leaving school and between positions for the last ten years.

From Mo./Yr.	To Mo./Yr.	State what you are doing	Persons who can confirm unemployment (give tel. #)

(Continued)

EMPLOYMENT APPLICATION

page 2

Education Background

Name	Address	Course of Study	Graduate? If Yes, state degree
High School:			
College:		Major: Minor:	
Graduate School:		Major: Minor:	

Are you still in school? If yes, where?

How many courses are you currently taking?

Number of credits:

What is the course of study?

Special Skills (fill in only if job related):

Do you speak any foreign languages?

Read? Write?

If there are positions or types of positions for which you should not be considered or job duties you cannot perform in a reasonable manner because of a physical, mental, or medical disability, please describe.

Personal Reference: Give the name, address, and telephone number of a personal reference other than a relative or employer.

Name	Address	Telephone #

Employee Responsibility to the Organization (Please read before signing.)

As a condition of my employment, I accept the principle that the welfare of the organization depends upon the conduct and honesty of the members of the staff and upon the trust and confidence of the public. Our clients rightly expect honesty, security, and confidentiality in their affairs. I therefore agree to the following:

1. I agree to give no unauthorized information relative to the accounts of the organization or its relation with others, and to discuss no matters of a confidential nature relating to the organization's affairs unless such discussion is in the necessary course of the organization's business and is in accordance with the organization's policy.
2. I also agree to inform the management of the organization, without delay, of any fraud, false entry, substantial error, embezzlement or employee misconduct which I discover or know to have taken place in any records, property, or funds of the organization, and to report any transaction or matter that seems damaging to the organization.

I acknowledge and understand that any violation of this Agreement may result in the termination of my employment.

Name

Signature

Date

(Continued)

EMPLOYMENT APPLICATION**page 3**

Please also read before signing. If you have any questions regarding this statement, please ask them of any interviewer before signing.

In the event of my employment with this organization, I will comply with all the rules and regulations as set forth in the organization's policy manual or other communications distributed to all staff members. I understand that such employment is conditioned upon a favorable health evaluation which may include a physical examination by a doctor selected by the organization and to which I hereby assent. I further agree to complete all necessary forms in that regard. Additionally, I authorize the organization to supply my employment record, in whole or in part, and in confidence, to any prospective employer, government agency, or other party with a legal and proper interest.

I certify that all statements made by me on this application are true and complete to the best of my knowledge and that I have withheld nothing that would, if disclosed, affect this application unfavorably. I understand this falsification could result in termination of my employment. In consideration of my employment, I agree to conform to the rules and regulations of the organization. I agree that my employment and compensation can be terminated with or without cause, and with or without notice, at any time, at the option of either the organization or myself. This is not a contract of employment. Any individual who is hired may voluntarily leave employment upon proper notice and may be terminated by the employer at any time. Any oral or written statements to the contrary are hereby expressly disavowed and should not be relied upon by any prospective or existing employee. I further understand and agree that any employment will be at the sole discretion of the organization. If accepted for employment, I agree to have my fingerprints and photograph taken for the purposes of identification and the maintenance of internal security. I understand that past employers/educational institutions or the military will be contacted for references. For reference purposes,

you may ☐ you may not ☐ contact my present employer.

I hereby acknowledge that I have read the above statement and understand the same.

Applicant's Signature

Date

8.604 CANDIDATE EVALUATION FORM

Rate Code:				
Favorable — Unfavorable				
1	2	3	4	5

Applicant Name: _____ For Position: _____

Interviewer Name: _____ Date: _____

Category	Rating	Comments
Neatness and poise Oral expression Responsiveness		
Work Experience Relevance Skill Level Process/Result Orientation Motivation Interpersonal Skills Initiative Leadership Growth and Development Teamwork		
Education Sufficiency Relevance		
Background Basic Values and Goals Attitudes Toward Achievement Self-image		
Present Activities and Interests Management of Time Energy Level Maturity and Judgment Intellectual Growth Diversity of Interests Social Skills Basic Values and Goals		
Strengths:		Weaknesses:
Summary and Recommendations:		

Final Rating

8.605 RECORD OF REFERENCE CHECK

Applicant: _____ Date: _____

Reference From: _____ Position: _____

Organization: _____ City/State: _____ Tel: _____

I would like to verify some of the information given to us by _____, who is applying for employment with our organization.

What are the dates of his/her employment with you? From/To _____

Please describe his/her job function: _____

How would you describe his/her:

Performance: _____

Dependability on completing assignments: _____

Supervision requirements: _____

Attendance: _____

Ability to take responsibility: _____

Work attitude: _____

Working relationship with co-workers: _____

Advancement potential: _____

Strengths: _____

Limitations: _____

Any personal difficulties that adversely affected his/her work: _____

What were his/her earnings? _____

Why did he/she leave your organization? _____

Would you reemploy? Yes: ____ No: ____ (Why not?) _____

Is there anything else that we should know? _____

CHAPTER 9
ASSIGNING PERSONNEL TO ENGAGEMENTS

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CHAPTER 9

ASSIGNING PERSONNEL TO ENGAGEMENTS

9.000 WHAT "ASSIGNING PERSONNEL TO ENGAGEMENTS" MEANS

9.001 You must establish policies and procedures to provide reasonable assurance that persons who work on an engagement have the degree of technical training and proficiency required under the circumstances. They must understand every aspect of what they are doing (including any peculiarities of each client).

Practice Tip:

This element does *not* have great significance to a firm with 10 or fewer professionals whose professional members have close personal contact on a day-to-day basis, understand each other's abilities and limitations, and account for these abilities and limitations in the day-to-day operations of the firm. For larger firms, it becomes more important to have a more sophisticated assignment system in place.

9.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA SQCS No. 1

9.101 Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirement to which you must adhere, and to which you must document compliance, in regard to assigning personnel to engagements:

Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

9.200 HOW TO ADDRESS ASSIGNING PERSONNEL TO ENGAGEMENTS

9.201 Your firm needs to develop some basic policies and procedures to ensure (and document) appropriate assignments of engagement personnel.

Basic Approach

9.202 To attain this goal, we believe you should:

1. Centralize authority, *and*
2. Develop appropriate procedures for staff assignments.

Centralize Authority

9.203 You should assign someone in the firm, such as the managing partner (or quality control partner or proprietor), to be the staff scheduler who has overall responsibility for assigning personnel to engagements and resolving conflicts related to assignments.

Develop Appropriate Procedures

9.204 If your firm is a small one that rarely adds new professionals or changes client assignments, dealing with staffing appropriately is relatively simple. The only concern is that someone must make sure that each client is assigned to a staff member who has the appropriate skills to handle the assignment. However, in a larger firm, this responsibility is more time-consuming and complex; whoever is responsible must know the abilities of the various staff members, as well as the various other demands on the staff's time (i.e., continuing professional education—CPE, vacations, etc.)

9.205 You can use various methods to enable the responsible individual to be aware of, and provide for, the assignment of responsibilities. There are at least two possibilities:

1. Have all the partners meet at appropriate intervals (monthly or quarterly) to assign the responsibilities for clients to staff members. At these meetings, the partners make sure that all jobs for which they have responsibility are adequately covered by staff that is appropriate, considering staff experience and training needs. In this approach, the staff scheduler normally acts as an arbitrator at the meetings and later makes sure that the decisions reached are communicated and implemented.
2. Have each partner submit written specifics about his or her individual job requirements to the individual responsible for the assignment of staff. That individual will then make the appropriate decisions, subject to final approval of the partner (see the Staff Assignment Request Form in section 9.602).

Practice Tip:

The second approach appears simpler at first glance. But it requires the individual responsible for assignments to communicate back and forth to resolve conflicts — instead of resolving them on the spot (as is done with the first approach).

9.300 SOME TIPS AND TECHNIQUES

Provide for Unexpected Conflicts

9.301 As you learned early in your career, clients are rarely, if ever, ready for you on the day they promise. On the other hand, you must comply with certain filing due dates and allow adequate time for quality and administrative concerns, such as proper review and supervision, typing, and proofreading. Staff scheduling must also allow for vacations, holidays, CPE courses, personal preferences, personality conflicts, and the like. Accordingly, your scheduler must be an individual who can handle change and cope with the need for *flexibility* in the scheduling process.

9.302 In addition, it is devastating to a staff member's morale to be caught in a conflict between partners. It also makes the staff think the firm is not unified.

Use Time Budgets

9.303 Time budgets are used in the supervision process (see Chapter 5). They are also of tremendous assistance in the personnel assignment process, particularly on continuing engagements. Proper use of time budgets includes the posting of actual time expended, which enables your scheduler to know exactly, by staff level, how much time a particular function took last year. Accordingly, time budgeting assists tremendously in determining when, and for how long, a particular staff level or person should be assigned this year. (See further discussion of staff levels in Chapter 10.)

Assign CPAs to Supervise Field Work

9.304 If possible, give a certified firm member the top field-level responsibility for all audit engagements and for larger non-audit financial statement engagements. It is much easier to show that an individual who has passed the CPA exam has demonstrated adequate professional knowledge and proficiency.

9.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE ASSIGNING PERSONNEL TO ENGAGEMENTS ELEMENT

9.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire: (See section 2.700 in Chapter 2)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Identifies on a timely basis the staffing requirements of specific engagements?
- Communicates its policies and procedures for assigning personnel to engagements to professional personnel?

- Appropriately considers the following factors in assigning partners and staff to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization:
 - Engagement size and complexity?
 - Timing of the work to be performed?
 - Special expertise required?
 - Continuity and periodic rotation of personnel?
 - Opportunities for on-the-job training?
 - Personnel availability?
- Notifies staff of work assignments on a timely basis?
- Complies with its policies and procedures for assigning personnel to engagements during the period and adequately documents its compliance to the extent required by firm policy?

9.500 SAMPLE POLICIES AND PROCEDURES

9.501 With regard to the assigning personnel to engagements element, *all* firms, regardless of their size, need to adopt certain *theories* behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. The AICPA sample appears below. Some of those theories are not needed for small firms in which there is more personal daily contact between the firm members than in larger firms. Alternative, simpler wording for these firms is provided in section 9.504.

AICPA Sample System

9.502 The AICPA's suggested sample policies (*in italics*) and procedures on assigning personnel to engagements read as follows:

1. *Delineate the firm's approach to assigning personnel, including the planning of overall firm and office needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.*
 - a. Plan the personnel needs for the firm on an overall basis and for individual practice offices.
 - b. Identify on a timely basis the staffing requirements of specific engagements.
 - c. Prepare time budgets for engagements to determine manpower requirements and to schedule field work.
 - d. Consider the following factors in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

- (i) Engagement size and complexity.
 - (ii) Personnel availability.
 - (iii) Special expertise required.
 - (iv) Timing of work to be performed.
 - (v) Continuity and periodic rotation of personnel.
 - (vi) Opportunities for on-the-job training.
- 2. *Designate an appropriate person or persons to be responsible for assigning personnel to engagements.*
 - a. Consider the following in making assignments of individuals:
 - (i) Staffing and timing requirements of the specific engagement.
 - (ii) Evaluations of the qualifications of personnel regarding experience, position, background, and special expertise.
 - (iii) The planned supervision and involvement by supervisory personnel.
 - (iv) Projected time availability of individuals assigned.
 - (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to engagements for clients who are former employers or are employers of certain relatives.
 - b. When assigning personnel, give appropriate consideration, to both continuity and rotation to provide for an efficient engagement and the perspective of personnel with different experience and backgrounds.
- 3. *Provide for approval of the scheduling and staffing of the engagement by the person with final responsibility for the engagement.*
 - a. Submit, where necessary, for review and approval, the names and qualifications of personnel to be assigned to an engagement.
 - b. Consider the experience and training of the engagement personnel in relation to the complexity or other requirements of the engagement and the extent of supervision to be provided.

Alternative Sample System

9.503 The following policy (*in italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

9.504 *It is our firm's policy to assign professional personnel to an engagement in a manner that provides for adequate technical coverage, determined by the requirements of the particular engagement, as well as to provide for the continued development of the professional personnel.*

The procedures listed below are to be followed with regard to this policy:

- The firm's managing partner (or quality control partner or proprietor) is responsible for the assignment of personnel to engagements, with the approval of the engagement partner, and for resolving any conflicts arising therefrom. The following criteria are to be employed:
 - a. The primary objective is to provide competent, timely service to our clients, in a manner that produces the highest possible quality of those services.
 - b. A secondary objective is to produce well-rounded professional personnel who receive adequate exposure to the various and sundry facets of the profession.

9.600 SAMPLE DOCUMENTATION

9.601 There are no minimum documentation requirements for assigning personnel to engagements. However, careful documentation of your scheduling process and evidence of partner approval of the staff assigned to each engagement are highly recommended, particularly for larger firms.

9.602 Staff Assignment Request Form**Engagement Information** (to be completed by engagement partner)

Client: _____ Date: _____

Engagement Partner: _____ Balance Sheet Date: _____

Nature of Engagement (check all that apply):

☐ Audit ☐ Review ☐ Compilation ☐ Tax Return ☐ Other (describe): _____

Industry and/or Specialized Skills Required: _____

Delivery Deadline (or date of anticipated delivery): _____

Financial Statements and Management Letter: _____

Tax Return: _____ Other: _____

Engagement Schedule and Time Budget

Phase	Scheduled Start Date	Current Budgeted Hours					
		Asst.	Asst.	In-Charge	Manager	Partner	Total
Planning and admin.	_____	_____	_____	_____	_____	_____	_____
Interim field work	_____	_____	_____	_____	_____	_____	_____
Inventory observation	_____	_____	_____	_____	_____	_____	_____
Confirmations	_____	_____	_____	_____	_____	_____	_____
Year-end field work	_____	_____	_____	_____	_____	_____	_____
Wrap-up	_____	_____	_____	_____	_____	_____	_____
Tax return	_____	_____	_____	_____	_____	_____	_____
Current year's budgeted hours		=====	=====	=====	=====	=====	=====
Prior year's actual hours		=====	=====	=====	=====	=====	=====

Suggested Current Staffing

Enter the names of the specific staff members and dates requested for this engagement.

Indicate with an asterisk (*) if staff member was part of prior year's staffing.

In-Charge: _____ Date(s): _____

Assistant: _____ Date(s): _____

Assistant: _____ Date(s): _____

Assigned Staff (to be completed by staff scheduler)

In-Charge: _____ Date(s): _____

Assistant: _____ Date(s): _____

Assistant: _____ Date(s): _____

Acceptance (to be completed by engagement partner)

Date: _____

Signature: _____

Print Name: _____

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ADVANCEMENT
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CHAPTER 10

ADVANCEMENT

10.000 WHAT "ADVANCEMENT" MEANS

10.001 Each member of your professional staff should know the exact nature of his or her current duties and responsibilities as well as what it will take to progress professionally in your firm. Your advancement policies and procedures must reasonably ensure that the employees you select for advancement have the qualifications necessary to fulfill the responsibilities they will assume. You should evaluate each member of your professional staff at least annually.

Practice Tip:

The function of this quality control element is not to require you to promote your personnel. On the contrary, its function is to cause you to show *restraint* in promoting your professional firm members and to promote them only when they are capable of handling the functions to which you promote them. The peer review process will monitor compliance with the advancement element of firms with 10 or fewer professionals by exception only.

10.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA SQCS No. 1

10.101 Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirements to which you must adhere, and which you must document compliance, in regard to advancement:

Policies and procedures for advancing personnel should be established to provide the firm with reasonable assurance that those selected for advancement will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume. Practices in advancing personnel have important implications for the quality of a firm's work. Qualifications that personnel selected for advancement should possess include, but are not limited to, character, intelligence, judgment, and motivation.

10.200 HOW TO ADDRESS ADVANCEMENT

10.201 Your firm must develop (and comply with) some basic policies and procedures, appropriate to its size, to ensure (and document) that it meets the advancement requirements.

Basic Approach

10.202 The authors believe that if your firm employs more than one or two professional staff members, the fundamentals are to:

1. Develop staff level definitions,
2. Classify your personnel accordingly, *and*
3. Use annual performance reviews to ensure that personnel are advanced at the proper rate.

10.203 If your firm employs only one or two professional staff members, less formality is required. However, you should still formally evaluate performance at least annually.

Define a Few Minimal Staff Levels

10.204 The simplest way for firms to comply with the requirements of the advancement element is to develop and adhere to some basic staff level definitions. These definitions, which will vary from firm to firm, should spell out job titles for professionals (including any paraprofessionals who are neither CPAs nor working toward CPA certification) and state the level of competence and experience expected of each. The definitions should address such items as:

- Level of familiarity with—
 1. Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board (GASB), and American Institute of Certified Public Accountants (AICPA) pronouncements on accounting and auditing matters;
 2. Procedural and conduct rules of the AICPA, state board, and relevant regulatory agencies; *and*
 3. Firm manuals and procedures;
- Level of responsibility on accounting and auditing engagements; *and*
- Required status with regard to certification.

See section 10.603 for a set of suggested staff level definitions that can serve as a starting point when you devise what is necessary for your firm.

Practice Tip:

Many local firms are reluctant to create staff levels. They feel it will distract from the team approach, and they do not want to make one professional staff member feel more or less important than another. However, in actual practice, your firm probably has these classifications already; the classifications simply are not documented. Your staff members probably are well aware of their standing in the organizational hierarchy, and they know how their skills compare to others'. In fact, once levels become official, staff members will find it easier to know exactly what they have to learn to progress within the firm.

Classify Professional Staff into Levels

10.205 Once you have developed and refined your staff levels, you will have to classify your present staff, as well as anyone you hire later, according to the levels that you have developed. Smaller firms may have only a few levels, such as assistant and in-charge; larger firms often add levels like semi-senior, supervisor, and manager. A few large firms even create additional levels, such as supervising senior and senior manager.

Practice Tip:

You do not need to go overboard in setting up staff levels. Use the smallest number of levels that will work for your firm. Do not fall into the trap of adding needless layers just because someone else has them. Instead, streamline your structure so that it makes sense for your own practice and mode of operations.

Practice Tip:

You generally will find classification easy, although you may encounter some complaints from staff members who feel that they were underevaluated. You are unlikely to hear complaints from any staff member about too high a rating. However, you should err on the side of conservatism. If you think someone needs a few more months of seasoning, experience, and training before rising to a certain level, you should classify that individual at the lower level, and then promote them at a later date.

Evaluate, Compensate, and Promote Rationally

10.206 At least annually, you should perform a *formal*, documented performance evaluation of each of your professional staff members. Raises and promotions should be tied to these evaluations.

Practice Tip:

Your peer reviewer may ask about your advancement policies and procedures. In addition to reviewing personnel files, your peer reviewer will interview some of your professional staff members — to learn about their perceptions of your quality control policies and procedures.

10.207 Performance Reviews. Formal performance reviews or evaluations let your staff members know where they stand in the overall scheme of things, what they have to do to progress to the next level, how they can be of greater benefit to the firm, and how they can achieve their own career goals and objectives.

10.208 Typically, a performance review evaluates an individual's professional skills and relevant interpersonal skills. It also rates an individual's performance with regard to his or her staff level, sets performance goals for the next year, and looks at whether goals for the past year have been achieved (see section 10.702).

Practice Tip:

It may be best, at least in local firms, to evaluate everyone at one time — perhaps at a partners' meeting. Such a practice enables you to make better comparisons of staff members. The evaluations might, for example, be made at the end of each year or tax season. However, staggered evaluation dates — such as employment anniversary dates or the conclusions of financial statement engagements — are often used as well.

Generally, in larger firms, a staff member's immediate supervisor performs an evaluation, or has input into it, while the partners make decisions regarding advancement and compensation.

10.209 Each performance review should be discussed with the staff member reviewed, and the staff member should have the opportunity to offer input on his or her review.

Practice Tip:

The results should be communicated to each individual at a closed-door session, with no interruptions. It is a good idea to obtain the staff member's signature — as evidence that the evaluation was communicated to the staff member. Although it is not relevant to your peer review, it may be advisable (for personnel law reasons) to permit the staff member to make a copy of the review for his or her personal records.

10.210 Raises and Promotions. In many local firms, individuals normally receive promotions and raises when they request them (the "squeaky wheel theory"). However, the *firm* should decide when promotions and raises are given, how much, and who gets them. A formal evaluation, at least annually, will help resolve this problem.

Practice Tip:

Use of a well-designed, *documented* performance review as the basis of compensation, promotion, and other employment decisions provides a collateral benefit. It helps protect you against discrimination charges. However, you should be careful not to include *subjective* evaluations of items like appearance. Evaluations based, for example, on weight and sexual stereotypes have created serious problems for all employers, including CPA firms.

10.300 SOME TIPS AND TECHNIQUES

Think Levels, Not Individuals

10.301 The most difficult concept for many local practitioners to accept is that, to comply with the advancement element of quality control, they should really think of job assignments in terms of the level of professional skill required to handle it — not in terms of particular names and faces. Although this approach may sound impersonal, the methodology helps you to develop well-rounded individual staff members and avoid favoritism.

10.302 The good people should, and will, be recognized and promoted relatively rapidly through the system. Appropriate promotions are the way you should recognize these individuals — not by overburdening them because you realize you can rely on them more than on others.

Keep on Schedule

10.303 Someone in the firm, normally the managing partner (or quality control partner or proprietor), must be responsible for ensuring that reviews are performed on schedule and properly documented.

10.304 In smaller firms, the actual evaluation forms, which capture everyone's input, normally are prepared at a partner's meeting. The responsible person must ensure that this meeting is held at the proper time and that participants have proper notice. In a larger firm, the responsible person must ensure that evaluations occur on schedule.

10.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE ADVANCEMENT ELEMENT

10.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the AICPA questionnaire. (See section 2.700 in Chapter 2.)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed and engagements reviewed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Has established appropriate qualifications for the various levels of responsibility within the firm?
- Has identified relevant criteria for evaluating individual performance and expected proficiency?
- Adequately communicates criteria for evaluating individual performance and expected proficiency to professional personnel?
- Appropriately evaluates the performance of partners and other professional personnel on a periodic basis?
- Provides for appropriate documentation of evaluations of performance?
- Appropriately evaluates the data obtained regarding performance and gives proper recognition in advancement decisions to the quality of work performed?
- Appropriately monitors the firm's advancement experience on a periodic basis to ascertain whether individuals meeting stated criteria are assigned increasing degrees of responsibility?
- Complies with its advancement policies and procedures during the period and adequately documents its compliance to the extent required by firm policy?

10.500 SAMPLE POLICIES AND PROCEDURES

10.501 With regard to the advancement element, *all* firms, regardless of their size, need to adopt certain *theories* behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. Firms with only one or two staff members need not adopt all of the AICPA theories. The AICPA sample appears below. Alternative, simpler wording for local firms is provided in section 10.503.

AICPA Sample System

10.502 The AICPA's suggested sample policies (in *italics*) and procedures on advancement read:

1. *Establish qualifications deemed necessary for the various levels of responsibility within the firm.*

- a. Prepare guidelines describing responsibilities at each level and expected performance and qualifications necessary for advancement to each level, including —
 - (i) Titles and related responsibilities.
 - (ii) The amount of experience (which may be expressed as a time period) generally required for advancement to the succeeding level.
 - b. Identify criteria that will be considered in evaluating individual performance and expected proficiency, such as the following:
 - (i) Technical knowledge.
 - (ii) Analytical and judgmental abilities.
 - (iii) Communicative skills.
 - (iv) Leadership and training skills.
 - (v) Client relations.
 - (vi) Personal attitude and professional bearing (character, intelligence, judgment, and motivation).
 - (vii) Possession of a CPA certificate for advancement to a supervisory position.
 - c. Use a personnel manual or other means to communicate advancement policies and procedures to personnel.
2. *Evaluate performance of personnel, and periodically advise personnel of their progress. Maintain personnel files containing documentation relating to the evaluation process.*
- a. Gather and evaluate information on performance of personnel.
 - (i) Identify evaluation responsibilities and requirements at each level in dictating who will prepare evaluations and when they will be prepared.
 - (ii) Instruct personnel on the objectives of personnel evaluation.
 - (iii) Utilize forms, which may be standardized, for evaluating performance of personnel.
 - (iv) Review evaluations with the individual being evaluated.
 - (v) Require that evaluations be reviewed by the evaluator's superior.

- (vi) Review evaluations to determine that individuals worked for and were evaluated by different persons.
- (vii) Determine that evaluations are completed on a timely basis.
- b. Periodically counsel personnel regarding their progress and career opportunities.
 - (i) Review periodically with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include the following:
 - (a) Performance.
 - (b) Future objectives of the firm and the individual.
 - (c) Assignment preferences.
 - (d) Career opportunities.
 - (ii) Evaluate partners periodically by means of counseling, peer evaluation, or self appraisal, as appropriate, regarding whether they continue to have the qualifications to fulfill their responsibilities.
 - (iii) Review periodically the system of personnel evaluation and counseling to ascertain that
 - (a) Procedures for evaluation and documentation are being followed on a timely basis.
 - (b) Requirements established for advancement are being achieved.
 - (c) Personnel decisions are consistent with evaluations.
 - (d) Recognition is given to outstanding performance.

3. Assign responsibility for making advancement decisions.

- a. Assign responsibility to designated personnel for making advancement and termination decisions, conducting evaluation interviews with persons considered for advancement, documenting the results of the interviews, and maintaining appropriate records.
- b. Evaluate data obtained giving appropriate recognition in advancement decisions to quality of the work performed.
- c. Study the firm's advancement experience periodically to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility.

Alternative Sample System

10.503 The following policy (in *italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

It is our firm's policy to evaluate its professional personnel on an annual basis to determine that they are appropriately classified according to the firm's staff level definitions. These definitions describe the knowledge and experience required at each level. They should also be used as a guide to determine what experience and knowledge an individual will need to gain in order to progress to the next level.

The procedures listed below are to be followed with regard to this policy:

On an annual basis, the managing partner (or quality control partner or proprietor) will oversee an evaluation process whereby all professional staff members are evaluated in order to determine whether they are appropriately classified at their current level or deserve a promotion.

10.600 SAMPLE PROFESSIONAL STAFF LEVEL DEFINITIONS

10.601 To comply with the advancement policies and procedures of the quality control standards, most CPA firms, except for very small ones, should document staff level classifications for their professional personnel. All CPA firms should, at a minimum, keep documentation of annual personnel evaluations in their personnel files.

10.602 The following sample is, of course, only one suggestion. It provides you with a format that you can adapt to the needs of your firm, as discussed in section 10.200. Note that the definition of "professionals" includes not only CPAs, but also those expected to obtain that status. If your firm employs paraprofessionals, describe their responsibilities as well.

10.603 The following are the staff levels for our firm and the qualifications and expectations therefor:

An *Assistant* is expected to:

1. Be familiar with important authoritative pronouncements, such as those of the FASB, GASB, and AICPA — such as Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARs) and applicable Audit and Accounting Guides.
2. Know rules, regulations, and codes of conduct of the AICPA, State Board of Accountancy, State CPA Society, and, when appropriate, the SEC or other regulatory agencies.
3. Be familiar with firm manuals and procedures.
4. Work on portions of accounting and auditing engagements.
5. Work towards passing CPA examination as expeditiously as possible.

An *In-Charge* is expected to:

1. Prepare financial statements and management letters.
2. Be responsible for small and medium-sized audit engagements and large unaudited engagements.
3. Perform work on engagements involving theory and conceptual areas such as materiality, audit risk, analytical procedures, identification of key engagement areas, sampling, etc.
4. Review and analyze internal control structures.
5. Prepare planning memorandums, work programs, and time budgets.
6. Recognize, in advance, possible engagement problems.
7. Supervise and train assistants.
8. Pass the CPA examination. (An In-Charge cannot be promoted to manager until certified.)

A *Manager* is expected to:

1. Supervise a number of engagements at the same time.
2. Participate in (a) assigning duties to and training of staff, (b) monitoring compliance with due dates, and (c) monitoring compliance with time budgets.
3. Review workpapers and completed financial statements and reports to ascertain that they meet professional standards and the standards of this firm.
4. Resolve problems before submitting financial statements and reports for final partner review.
5. Assist in communicating firm policies and technical information to staff.
6. Motivate and assist staff members in their development.
7. Represent the firm in professional and service organizations, and promote the firm's reputation by conducting seminars, giving speeches, writing articles, and carrying out similar activities.
8. Assist partner(s) with practice development and practice management.

10.700 SAMPLE DOCUMENTATION

10.701 The following Staff Evaluation Form evaluates an individual's professional and interpersonal skills. It rates performance with regard to his or her staff level, sets performance goals for the year, and considers whether the staff member achieved the goals set for the past year.

10.702 Staff Evaluation Form

Employee: _____
 Years With Firm: _____ Present Salary: _____
 Years in Practice: _____ Present Staff Level: _____
 Last Promotion Date: _____

	<u>Above Average</u>	<u>Average</u>	<u>Below Average</u>	<u>No Basis</u>
Professional Skills				
1. Planning and administration	_____	_____	_____	_____
2. Workpapers and products — content and neatness	_____	_____	_____	_____
3. Technical ability	_____	_____	_____	_____
4. Research ability	_____	_____	_____	_____
5. Timeliness — Meeting of deadlines	_____	_____	_____	_____
Interpersonal Skills				
1. Relations with staff	_____	_____	_____	_____
2. Relations with clients	_____	_____	_____	_____
3. Accepts responsibility	_____	_____	_____	_____
4. Follows instructions	_____	_____	_____	_____
5. Creativeness and inquisitiveness	_____	_____	_____	_____
6. Expression — Oral	_____	_____	_____	_____
7. Expression — Written	_____	_____	_____	_____
8. Neatness and poise	_____	_____	_____	_____
9. Attendance and punctuality	_____	_____	_____	_____
10. Enthusiasm	_____	_____	_____	_____
11. Teamwork	_____	_____	_____	_____
12. Leadership	_____	_____	_____	_____
13. Growth potential	_____	_____	_____	_____

Accomplishments of Prior Goals: _____

Practice Development Efforts and Results: _____

Accomplishments to Meet Next Staff Level Definition: _____

Future Goals: _____

Comments and Decisions: _____

Employee Comment(s), if any: _____

Prepared By: _____ Date: _____

Reviewed By: _____ Date: _____
(Managing Partner/Personnel Partner)

Employee: _____ Date: _____

CHAPTER 11

INSPECTION

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CHAPTER 11

INSPECTION

11.000 WHAT "INSPECTION" MEANS

11.001 Under normal circumstances, your firm will undergo a peer review once every three years. At least in the two interim years, when your firm is not reviewed, you must be sure that your quality control system is still working properly. The inspection element addresses this need in your quality control system.

11.002 You must establish policies and procedures to provide reasonable assurance that your policies and procedures relating to the eight other elements of quality control are continuing to be effectively applied.

Practice Tip:

No matter what size your firm is, inspection helps you determine that your quality control system, as defined by the other eight elements (see Chapters 3–10), is still working as you have designed it to work and as you expect it to work in the periods between your reviews, which occur only once every three years. The peer review process will monitor compliance, by exception only, with the inspection element in firms with 10 or fewer professionals — unless they feel you could have caught your own problems had you done an inspection. It will be stressed, however, for PCPS and SECPS firms.

11.100 REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

11.101 SQCS No. 1. Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, states the basic quality control requirements to which you must adhere, and to which you must document compliance, in regard to inspection:

Policies and procedures for inspection should be established to provide the firm with reasonable assurance that the procedures relating to the other elements of quality control are being effectively applied. Procedures for inspection may be developed and performed by individuals acting on behalf of the firm's management. The type of inspection procedures used will depend on the controls established by the firm and the

assignment of responsibilities within the firm to implement its quality control policies and procedures.

11.102 Interpretations of SQCS No. 1. The American Institute of Certified Public Accountants (AICPA) Quality Control Executive Committee has issued three interpretations of SQCS No. 1. These interpretations are entitled:

1. The Relationship Between Inspection and Monitoring,
2. Implementation of Inspection in CPA Firms, and
3. Documentation of Compliance With a System of Quality Control.

11.103 The Relationship Between Inspection and Monitoring. This July 1980 interpretation states that the objective of inspection is to determine compliance with quality control policies and procedures in effect during a period of time. Inspection procedures contribute to the monitoring function.

Practice Tip:

In practical terms, your inspection will ordinarily occur only once each year, when you survey your practice to see if your quality control system is working properly and to assure yourself that your work product satisfies professional standards or your own, whichever are higher.

Monitoring, however, is a process that occurs on a more frequent basis, as in, for example, your preissuance review of workpapers and financial statements.

Practice Tip:

Some monitoring procedures may become a part of your inspection procedures. If, for example, your managing partner periodically examines personnel files or continuing professional education (CPE) records in order to stay abreast of your firm's operations, you may be able to treat that review as a part of your inspection procedures.

11.104 Implementation of Inspection in CPA Firms. This July 1980 interpretation requires firms to apply inspection procedures to each of the elements of quality control at least annually. A peer review fulfills the firm's annual inspection requirements for the year covered by the peer review.

11.105 Small firms, and particularly sole proprietors, have reported difficulty in carrying out their inspections. The interpretation points out that a sole proprietor can inspect his or her own policies and procedures using the AICPA's checklists and materials or alternative ones. Alternatively, a sole proprietor can engage a qualified outside individual to perform the inspection procedures.

11.106 An engagement partner's review of workpapers and reports does not satisfy the inspection requirement, but a *second* management-level, preissuance review may substitute for a portion of your

inspection program if it is equivalent to the review your firm would perform as an inspection procedure. Findings should be periodically summarized, and appropriate actions should be taken to correct any deficiencies that have been noted.

11.107 Documentation of Compliance With a System of Quality Control. This June 1982 interpretation emphasizes that the form and extent of your documentation of compliance with your system varies depending on firm size, degree of operating autonomy, the nature of your practice, your organization, and appropriate cost-benefit considerations. It states that "documentation should be sufficient to enable those conducting an inspection to ascertain the extent of a firm's compliance with its system of quality control, including its compliance with inspection policies and procedures."

11.200 HOW TO ADDRESS INSPECTION

11.201 Your firm must develop and comply with some basic policies and procedures to ensure (and document) that it has an adequate inspection program.

Basic Approach

11.202 To satisfy the inspection element, your firm should:

1. Inspect appropriately,
2. Document properly (using memoranda or forms that summarize your inspection's scope and findings, as well as the actions you take on its findings), *and*
3. Take whatever corrective action the inspection indicates is necessary — including informing all professional personnel of required corrective action.

Inspect Appropriately

11.203 At least during the two interim years between peer reviews, the managing partner (or proprietor) should assign inspection responsibility. The responsible person can appoint an inspection "team" to perform the annual inspection, perform it himself or herself (a "team" can consist of only one individual in smaller firms), or — particularly if lack of objectivity, ability, or time is a concern — hire an outside consultant to do it.

11.204 Inspection Scope. The inspection itself, which is sometimes described as a mini-review, does not have to be the same as a full-fledged peer review. But you should follow some of the basic peer review guidelines and try to:

- Select at least one engagement of each accounting and auditing practice partner,
- Select at least one engagement from industries of high public interest or high exposure,
- Select at least one engagement from each of your firm's areas of specialization,
- Select an initial engagement, and
- Review all of the applicable quality control elements (not just supervision).

Practice Tip:

You can accomplish all of the above by looking at only a few files because each file can cover several criteria.

Document Scope and Findings

11.205 Your inspection team should prepare an official written report on the scope of its inspection and its findings.

Take Corrective Action

11.206 Most importantly, *you must correct any deficiencies that the inspection team notes*. Correction will be an extremely important area of concentration in the peer review process — even though inspection will not be officially stressed in peer reviews of firms with 10 or fewer professionals. Your peer reviewer will, in all probability, look at inspection reports and pay particular attention to the corrective actions your firm has taken — including informing all professional personnel of required corrective action. Your peer reviewer will also probably look at whether your firm followed through on promised corrective actions in subsequent engagements.

11.300 SOME TIPS AND TECHNIQUES**Stress the Interim Years**

11.301 Although it is a good idea for you to perform an inspection for the year of your peer review, you may not have the time or the inclination to do so. You are not required to inspect in the year for which you are peer reviewed, but an inspection is a good way to assure yourself that you are indeed ready for your peer review. It is far better for you to uncover an area of noncompliance than it is for your peer reviewers to find it.

11.302 You are, however, required to perform an inspection of your quality control system for each of the two interim years for which you are not being peer reviewed.

Keep Your Inspector Independent

11.303 Nothing prohibits anyone, even a sole practitioner, from performing his or her own inspection; but someone too close to the process is likely to lack the proper perspective. If at all possible, someone otherwise unassociated with your quality control process should perform your inspection. Likewise, whenever possible, inspection of a specific engagement should be assigned to someone who is independent of the engagement.

11.304 If your firm has both a managing partner and a quality control partner, the managing partner should either perform the inspection personally or appoint someone else to perform it under his or her authority. If a firm does not have enough partners or high-level managers to spread the responsibility, you might want to consider engaging an outsider to perform your inspection.

Exceed the Letter of the Law

11.305 At present, as previously mentioned, the peer review process does not formally stress the inspection element for firms with 10 or fewer professionals. However, those firms should perform an annual inspection, at least during the two interim years. An inspection enables you to make sure that everyone in the firm is still on the proper wavelength and that everything is functioning as intended.

Practice Tip:

Using appropriate members of your professional staff to perform portions of your inspection is an outstanding way to teach them about quality control and professional standards. A properly handled inspection is also an effective way to boost team spirit and morale.

11.400 SUMMARY: WHAT YOUR REVIEWERS MUST CONCLUDE ABOUT THE INSPECTION ELEMENT

11.401 At the conclusion of their work, your peer reviewers need to be able to respond positively to the following questions on the questionnaire. (See section 2.700 in Chapter 2.)

Based on reading the information obtained from the questionnaire filled out by the reviewed firm and other relevant written firm materials, discussions with firm personnel, and the results of the specific procedures performed, do you conclude (after giving due consideration to factors such as the size of the firm, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations) that the firm:

- Has established appropriate inspection procedures to provide reasonable assurance that the firm's quality control policies and procedures in other areas are operating effectively?
- Has established appropriate qualifications for personnel who participate in inspection activities?
- Has performed and documented a comprehensive inspection:
 - i. Covering the year under review?
 - ii. Covering the two preceding years?
- Has discussed inspection findings with appropriate personnel?
- Has taken or planned appropriate corrective actions with respect to inspection findings?
- Adequately monitors the corrective actions taken?

11.500 SAMPLE POLICIES AND PROCEDURES

11.501 With regard to the inspection element, all firms, regardless of their size, need to adopt the theories behind, but not necessarily the exact wording of, the AICPA's suggested sample policies and procedures. The AICPA sample appears below. Alternative, simpler wording for local firms is provided in section 11.504.

AICPA Sample System

11.502 The AICPA's suggested sample policies (in *italics*) and procedures on inspection read as follows:

1. *Define the scope and content of the firm's inspection program.*
 - a. Determine the inspection procedures necessary to provide reasonable assurance that the firm's other quality control policies and procedures are operating effectively.
 - (i) Determine objectives and prepare instructions and review programs for use in conducting inspection activities.
 - (ii) Provide guidelines for the extent of work at practice units, functions, or departments, and criteria for selection of engagements for review.
 - (iii) Establish the frequency and timing of inspection activities.
 - (iv) Establish procedures to resolve disagreements that may arise between reviewers and engagement or management personnel.
 - b. Establish qualifications for personnel to participate in inspection activities and the method of their selection.
 - (i) Determine criteria for selecting reviewers, including levels of responsibility in the firm and requirements for specialized knowledge.
 - (ii) Assign responsibility for selecting inspection personnel.
 - c. Conduct inspection activities at practice units, functions, or departments.
 - (i) Review and test compliance with applicable quality control policies and procedures.
 - (ii) Review selected engagements for compliance with professional standards, including generally accepted auditing standards, generally accepted accounting principles, and with the firm's quality control policies and procedures.
2. *Provide for reporting inspection findings to the appropriate management levels and for monitoring actions taken or planned.*

- a. Discuss inspection review findings on engagements reviewed with engagement management personnel.
- b. Discuss inspection findings of practice units, functions, or departments reviewed with appropriate management personnel.
- c. Report inspection findings and recommendations to firm management together with corrective actions taken or planned.
- d. Determine that planned corrective actions were taken.

Alternative Sample System

11.503 The following policy (in *italics*), with procedures, is an alternative to the AICPA language. You should use it as a guide, adapting it to meet your own special needs. Optional language is indicated in parentheses.

11.504 *It is our firm's policy to inspect our quality control system on an annual basis during the two interim years between peer reviews.*

The procedures listed below are to be followed with regard to this policy:

1. Approximately two months after the end of each fiscal year for which the firm is not undergoing a peer review, our managing partner (or proprietor) will appoint an inspection team (or will arrange for someone with appropriate knowledge from outside the firm) to perform an inspection.

The inspection team will not begin its work until approximately three months after the end of the firm's fiscal year, which will allow for the issuance of financial statements for all clients with fiscal years ending within the firm's fiscal year.

2. The inspection team will complete the appropriate steps (as listed below) and will prepare a written report thereon:
 - a. *Independence*: The inspection team will review (i) a sample of personnel files to determine that current independence representations have been obtained and that any questions were resolved and (ii) a sample of engagement files to determine that there was consideration, and documentation, of independence during engagement planning.
 - b. *Consultation*: The inspection team will review (i) a sample of engagement files to determine that proper research and consultation practices, including documentation, are being followed; (ii) our library to determine that it is up to date in all important matters; and (iii) our consultation documentation file to determine that it is being maintained on a current basis.
 - c. *Supervision*: The inspection team will review a sample of engagement files to determine that proper supervision practices, including documentation, are being followed.
 - d. *Professional Development*: The inspection team will review a sample of personnel files and professional development files to determine that proper professional development practices, including documentation, are being followed.
 - e. *Acceptance and Continuance*: The inspection team will review a sample of engagement files and acceptance and continuance paperwork to determine that proper acceptance and continuance practices, including documentation, are being followed.

- f. *Hiring*: The inspection team will review a sample of personnel files for employees hired during the inspection period to determine that proper hiring practices, including documentation, are being followed.
 - g. *Assigning Personnel To Engagements*: The inspection team will review a sample of engagement files to determine that proper assignment practices, including documentation, are being followed.
 - h. *Advancement*: The inspection team will review a sample of personnel files to determine that proper advancement practices, including documentation, are being followed.
- 3. The firm's partners will (a) review the inspection team's findings and (b) prepare a list of appropriate corrective actions with which the firm will comply once the list has been accepted by the partners. The managing partner (or proprietor) will monitor compliance.
 - 4. A copy of the inspection team's findings, as well as the list of corrective actions taken, will be made available to the following year's inspection team (and/or the firm's peer reviewers) so that compliance with regard to corrective action can be monitored.

11.600 SAMPLE DOCUMENTATION

11.601 At a minimum, your documentation should consist of memoranda summarizing:

- The scope of your inspection,
- The findings, including necessary corrective actions, and
- The actions taken on those findings.

11.602 The following materials are reprinted from the *AICPA Peer Review Program Manual (PRPM)*.

- Checklist for Coordinating an Inspection Program (Source: PRP sec. 10,000.49)
- Program for Inspection of Compliance With Policies and Procedures Related to the Elements of Quality Control (Source: PRP sec. 10,000.50)
- Optional Program for Review of Compliance with the Division of CPA Firms' Membership Requirement (Source: PRP sec. 10,000.51)
- Sample Inspection Report (Source: PRP sec. 10,000.52)

11.603 Checklist for Coordinating an Inspection Program

	<u>Initial</u>	<u>Date</u>
1. Determine who will coordinate the inspection program for the firm.	_____	_____
2. Determine who will perform the inspection.	_____	_____
3. Establish the approach and timetable for performing the inspection procedures.	_____	_____
4. Determine forms and checklists to be used during the inspection and the extent of documentation required.	_____	_____
5. Make a selection of engagements for review.	_____	_____
6. Review administrative files for compliance with the firm's quality control policies and procedures.	_____	_____
7. Review the selected engagements.	_____	_____
8. Summarize the inspection findings and determine what corrective actions should be taken.	_____	_____
9. Prepare an inspection report covering the scope of the inspection, the inspection findings, and the recommended corrective actions.	_____	_____
10. Decide how long to retain detailed inspection working papers.	_____	_____
11. Review the recommended corrective actions and reach final conclusions on the actions to be taken.	_____	_____
12. Communicate the inspection findings and the planned corrective actions to the other members of the firm (if any).	_____	_____
13. Follow-up on planned corrective actions to determine whether the actions were taken as planned and whether they achieve the objective(s) for which they were planned.	_____	_____

11.604 Program for Inspection of Compliance With Policies and Procedures Related to the Elements of Quality Control

Period Covered _____

	Findings, Including Extent of Testing	Done by
Independence		
1. Identify a sample of situations in which independence questions arose during the period being inspected and consider whether the resolution of such questions appears appropriate.		
2. Review the written independence confirmations obtained by the firm for a sample of professional personnel, if required by firm policy.		
3. Determine by review of appropriate documentation and by discussions with selected staff that the firm has advised all professional personnel on a timely basis of entities to which the independence rules apply and that professional personnel are familiar with the firm's independence policies and procedures.		
4. Determine by a review of selected engagements whether fees were paid for the prior year's services prior to the issuance of the current year's report.		
Consultation		
1. Inspect the firm's library for its audit and accounting practice and determine whether it is sufficiently comprehensive and current. Specifically determine that the library includes recent pronouncements and literature appropriate for the firm's specialties and that loose-leaf services are filed on a timely basis.		
2. On the engagements reviewed, determine whether consultation took place and was documented in accordance with the firm's policies.		
3. If sufficient testing of consultation policies and procedures was not performed in (2) above, determine through inquiry or review of subject files whether consultations took place and were correctly applied.		

	Findings, Including Extent of Testing	Done by
<p>Supervision</p> <p>1. On the engagements reviewed:</p> <ul style="list-style-type: none"> a. Determine whether the technical materials (audit manuals, standardized forms, checklists, and questionnaires) that are required by firm policy were used. b. Evaluate whether the technical materials are sufficiently comprehensive and up-to-date. c. Determine whether the firm complied with its policies and procedures for the review of engagement working papers, reports, and financial statements. d. Determine whether the firm's procedures for resolving differences of opinions among members of the engagement team were followed and are appropriate. <p>Professional Development</p> <p>1. Review the firm's CPE records on a test basis and consider whether:</p> <ul style="list-style-type: none"> a. They appear adequate to demonstrate compliance with AICPA, state board, and state society requirements and whether they indicate that the firm's plans for CPE were carried out. b. Professional personnel have complied with the CPE requirements set forth in <u>Government Auditing Standards</u> (if applicable). c. Professional personnel have complied with the Section's requirements (if the firm is a member of either the PCPS or the SECPS). <p>Assigning Personnel to Engagements</p> <p>1. Determine whether staffing and scheduling requirements were identified on a timely basis and approved by appropriate personnel.</p> <p>2. Determine by interviews with selected staff whether they believe the assignments they have received are appropriate.</p>		

	Findings, Including Extent of Testing	Done by
Hiring		
1. Determine by reviewing personnel files of recently hired employees whether: a. The background information and other documentation required by firm policy were obtained. b. The individuals possessed the desired attributes, achievements, and experience and, if not, why an exception was made.		
Advancement		
1. Determine by reviewing personnel files whether personnel have been evaluated and promoted in accordance with the firm's policies and procedures.		
Acceptance and Continuance of Clients		
1. Review the documentation maintained for selected acceptance and continuance decisions and evaluate whether the firm is complying with its policies and procedures and with professional standards.		
Inspection		
1. Determine whether appropriate corrective actions were taken, including effective follow-up, with respect to the prior period's inspection findings.		

11.605 Optional Program for Review of Compliance with the Division for CPA Firms' Membership Requirements

Period Covered _____

	Findings, Including Extent of Testing	Done by
<p>I. Requirements for Members of the PCPS and SECPS</p> <ol style="list-style-type: none"> 1. Determine whether each proprietor, shareholder, or partner of the firm, resident in the United States and eligible for AICPA membership, is a member of the AICPA. 2. Determine whether a majority of the members of the firm are CPAs (a separate determination may not be necessary, depending on the results of the previous step). 3. Determine whether the firm filed its most recent annual report with the section. <p>II. Additional Requirements for Members of SECPS</p> <ol style="list-style-type: none"> 1. Determine whether the firm has complied with the requirements for rotation of partners on SEC engagements. 2. Determine whether a concurring review was performed, prior to the issuance of any audit report on the financial statements of SEC clients, of the audit reports, financial statements, and selected working papers by a partner qualified to do such review, who is other than the audit partner in charge of the engagement. 3. Determine whether the firm has refrained from performing those management advisory services that are proscribed by the SECPS. 4. Determine whether the firm maintains documentation in the working papers of its annual report to the audit committee or board of directors of each SEC audit client on the total fees received from the client for management advisory services during the year and a description of the types of services rendered. 5. Determine whether the firm has reported to the Quality Control Inquiry Committee on a timely basis litigation or other actions against it or its personnel in situations required by the SECPS. 		

	Findings, Including Extent of Testing	Done by
6. Determine whether the firm communicated in writing on a timely basis to an SEC registrant and the Office of the Chief Accountant of the SEC when the client-auditor relationship with the SEC registrant ceased.		
7. Determine whether the firm has developed a statement of firm philosophy and communicated that statement to professional personnel on a periodic basis.		

11.606 Sample Inspection Report

Inspection period from _____ to _____

Name of inspectors _____

Timing of Inspection _____

Briefly describe the inspection program (including major considerations in selecting engagements and offices to be reviewed). _____

Scope of engagements reviewed:

	<i>Firm Totals*</i>		<i>Engs. Reviewed *</i>	
	<i>Hrs.</i>	<i>No. of Engs.</i>	<i>Hrs.</i>	<i>No. of Engs.</i>
Audits				
Reviews				
Compilations				
Other Accounting Services	_____	_____	_____	_____
Total	=====	=====	=====	=====

Percentage of A&A Practice Reviewed _____

Did the inspection disclose any situations that would require the firm to take action to prevent future reliance on a report issued by the firm or require the firm to perform additional auditing or review procedures to provide a basis for the report issued? If yes, describe the situation and the action taken by the firm. _____

The inspection findings and recommendations regarding actions taken for improvements in the firm are attached.

Inspection Coordinator Signature _____ Date _____

Approved _____ Date _____

* Approximate totals may be used.

CHAPTER 12

SUMMARY OF MINIMUM DOCUMENTATION RECOMMENDATIONS AND OTHER KEY COMPLIANCE CONSIDERATIONS

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CHAPTER 12

SUMMARY OF MINIMUM DOCUMENTATION RECOMMENDATIONS AND OTHER KEY COMPLIANCE CONSIDERATIONS

12.000 OVERVIEW

12.001 If you are typical, you go through many thought processes and make many decisions during a financial statement engagement which, although important, often are not reduced to writing (documented). You should recognize by now that you are probably going to have to make some changes in your practice as you get ready for your peer review.

12.002 This chapter summarizes and brings together the various ideas explained in this Manual about how you can begin to think in terms of *documenting*, in your workpaper files, the important procedures, evaluations, discussions, and decisions that you make in the course of each engagement. It also reiterates how you can document matters that are not engagement-specific. In the process, it provides you with a practice-oriented summary of what the nine elements of quality control mean and summarizes certain other key compliance considerations.

12.003 Keep in mind that the recommendations in this chapter reflect the authors' *suggestions* for documentation levels for small and medium-sized practices. They may not necessarily be appropriate for your own practice without at least some fine tuning. The American Institute of Certified Public Accountants (AICPA) has *not* established minimum levels of documentation. Chapters 3 through 11 provide you with more detailed information about each of the nine elements of quality control.

Quality Control Document Versus Quality Control Documentation

12.004 At various places in this Manual, you will see the term "quality control document." Your firm's quality control *document* contains its actual written quality control policies and procedures. Quality control *documentation* is the written evidence that you have complied with your firm's quality control policies and procedures—particularly in engagement files. For the most part, *documentation* is what this chapter is about.

12.100 TECHNICAL REQUIREMENTS AND AUTHORITATIVE LITERATURE

AICPA Literature

12.101 The AICPA's Quality Control Standards Committee has issued an interpretation of Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, entitled *Documentation of Compliance With a System of Quality Control*. This June 1982 interpretation

emphasizes that the form and extent of your documentation of compliance with your system will vary depending on firm size, degree of operating autonomy, the nature of your practice, your organization, and appropriate cost-benefit considerations. It concludes that "documentation should be sufficient to enable those conducting an inspection to ascertain the extent of a firm's compliance with its system of quality control, including its compliance with inspection policies and procedures."

12.200 MINIMUM DOCUMENTATION RECOMMENDATIONS: ELEMENT BY ELEMENT

12.201 Always be prepared to document your firm's compliance with each of the nine elements of quality control applicable to your firm's practice. How to adopt, implement, and document adherence to policies and procedures with regard to each element is addressed, in much greater detail, in Chapters 3 through 11. The following recommendations are a brief summarization of typical suggestions for a small or medium-sized practice.

Independence

12.202 Inherent in any quality control system is the underlying philosophy that your firm will closely adhere to, and monitor its compliance with, the pervasive professional requirements such as AICPA and state accountancy board independence rules. For audits and reviews, your firm must be independent in appearance as well as in fact. For compilations, your firm must make a disclosure if you are not independent. Regardless of how small your practice may be, it should establish policies and procedures to provide reasonable assurance that all persons in the firm, at all levels, maintain independence in fact and in appearance.

12.203 Actual peer reviews have demonstrated the following documentation problems with regard to independence:

1. Failure to document how the firm monitored compliance with independence requirements,
2. Failure to document how independence questions were resolved, *and*
3. Failure to comply with independence requirements.

12.204 Minimum Documentation Recommendations for Independence. Your firm's documentation should show that the firm monitors compliance with its independence policies and procedures. Although not required, the authors recommend that your firm should have:

1. Annual written representations of independence from professional staff members,
2. Memoranda of inquiry about specific independence questions and their resolutions, *and*
3. Written representations from other auditors, if any.

Practice Tip:

You may also want to consider obtaining the following as alternatives or supplements to annual written representations:

1. Written representations on each time summary sheet *or*
2. Sign-offs on each engagement program.

Consultation

12.205 Consultation, as the term is used here, does not refer to the consulting services that you provide to your clients but to the assistance you request from others because of the nature of a professional situation or because your knowledge and experience in a particular area are limited. In such instances, it is important to seek guidance from appropriate sources such as professional literature or fellow professionals who might be more knowledgeable about a particular subject than you are. Your firm's consultation policies and procedures should reasonably ensure that you and your staff will seek assistance, to the extent required, from persons having the required knowledge, competence, and judgment under the circumstances.

12.206 Actual peer reviews have shown the following key problems with regard to consultation:

1. No documentation of whether consultation took place when needed,
2. Out of date or inadequate library, *and*
3. Failure to consult AICPA Industry Audit and Accounting Guides or other appropriate sources.

12.207 Minimum Documentation Recommendations for Consultation. Your firm's documentation should record consultations with reference materials or with other persons or firms, including a description of the problem and the conclusions reached. In addition, an adequate reference library or access to one is essential to satisfying the consultation element. This includes access to industry accounting and auditing guides for any specialized industries that your firm serves.

Supervision

12.208 Supervision is probably the most important of all the quality control elements because it encompasses engagement planning and final review as well as field supervision. Under the AICPA's quality control standards, supervision includes any and all policies and procedures that the accounting and auditing firm must adopt and implement, and with which it must ensure compliance, in order to adhere to professional pronouncements and standards. Therefore, supervision as a quality control element encompasses overseeing not only engagement staff but also the firm's entire standardized approach to engagements—from planning to time budgets, to work programs, to field work, to review, to the accountant's or auditor's report, and so forth. To emphasize the pervasiveness of supervision in a professional practice, a proposal is under consideration to rename this area "engagement conduct."

12.209 Be sure to establish policies and procedures for the planning, conduct, supervision, and review of work at all levels to provide reasonable assurance that all work performed meets your firm's—and the profession's—standards. If no one in your firm can review your work or the work of your staff, consider hiring someone capable of doing so on an hourly or contract basis. Make certain that your firm's working papers clearly document the *entire* engagement planning process, particularly in the case of audits.

12.210 Without question, most of the comments arising during peer reviews relate to the area of supervision. Supervision also overlaps many of the other elements of quality control. Actual peer reviews show that firms often fail to document the following audit steps:

1. Engagement planning,
2. Understanding of internal control structure,
3. Application of analytical procedures,
4. Consideration of risk and materiality,
5. Review of working papers,
6. Audit sampling considerations,
7. Application of recent professional pronouncements, *and*
8. Evaluation of going concern.

12.211 One of the most common review findings is that financial statements omitted certain disclosures required by professional standards; while not required, the authors believe that a good reporting and disclosure checklist will help you avoid this problem.

12.212 Basic Audit Workpaper Guidance. Paragraph 5 of SAS No. 41, *Working Papers* (AU 339.05), provides guidance on workpaper content and states that "they should be sufficient to show that the accounting records agree or reconcile with the financial statements or other information reported on and that the applicable standards of fieldwork have been observed." Some documentation required that peer reviewers sometimes find to be lacking in the engagements they review are:

- Inquiry of a client's lawyer concerning litigation, claims, and assessments (AU 337);
- Written representations from management (AU 333);
- Workpaper documentation of internal control structure related matters if they were communicated orally (AU 325);
- The understanding of the internal control structure elements obtained to plan the audit (AU 319);
- Workpaper documentation if illegal acts were communicated orally (AU 317);
- Workpaper documentation if certain matters regarding the scope and results of the audit were communicated orally to the audit committee (AU 380); *and*
- Written audit program (AU 311).

12.213 Minimum Documentation Recommendations for Supervision. At a minimum, the authors recommend that your firm document the following with regard to each engagement (or, where noted, each audit engagement):

1. Engagement partner's review of work performed;
2. Engagement planning steps;
3. On each audit engagement, the understanding of internal control structure;
4. Analytical procedures for audits and reviews;
5. Evaluation of "going concern" considerations;
6. Risk assessment;
7. Review and assessment of materiality considerations;
8. Items that are required by generally accepted auditing standards, e.g., lawyer's letters and management representation letters; *and*
9. Consideration of recent technical pronouncements.

Practice Tip:

Ensure that relevant working papers are completed for all of these items and placed in the engagement file. That file should provide a trail that leads to the report, if any, rendered on the financial statements. The authors strongly recommend that you use reporting and disclosure checklists and that these checklists be current and, where applicable, tailored to the reporting requirements of specialized industries.

Practice Tip:

The authors believe it is desirable to adopt a series of standard engagement forms, which will enable you to control and document each engagement. Although it is not required, a concurring review is also highly desirable.

Professional Development

12.214 One of the easiest ways to get into trouble is to take on an engagement that your firm is not qualified to handle. The first general standard of SAS No. 1 reads:

The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

12.215 A firm that does one or two audits a year is unlikely to be as adequately technically trained and proficient in auditing as one that performs numerous audits. Hands-on auditing experience is necessary

to meet the proficiency requirement. Thus, in the context of your firm's quality control system, the professional development element means that you must be careful and know your limitations.

12.216 Each AICPA member must attend an average of 40 hours of approved Continuing Professional Education (CPE) courses per year, and your firm needs to monitor compliance with this rule. Also, it is important for everyone in your firm to be in strict compliance with any CPE requirements of your state board of accountancy.

12.217 Your firm's professional development policies and procedures should reasonably ensure that your personnel will have the knowledge necessary to fulfill the responsibilities that you assign to them, including work in specialized industries.

12.218 Actual peer reviews have shown that little or no CPE on accounting and auditing matters (or in specialized industries served by a firm) is a very common problem, as is failure to comply with the CPE requirements of the AICPA Division for CPA Firms. Be sure that you and your staff receive well-rounded CPE; 40 hours of excellent tax courses, for example, will not help someone trying to conduct an audit.

Practice Tip:

Remember that if your firm conducts *any* audits under *Government Auditing Standards* (the Yellow Book), you must comply with its CPE standards. Anyone who plans, directs, conducts, or reports on government audits covered by the yellow book must complete 80 hours of CPE every two years (minimum of 20 hours each year). At least 24 of the 80 hours should be in subjects directly related to government auditing.

12.219 Minimum Documentation Recommendations for Professional Development. At a minimum, your firm should comply with its policies and procedures, and you should document that:

1. All personnel have complied with applicable state CPE requirements,
2. All AICPA members have complied with AICPA CPE requirements, *and*
3. If applicable, your firm has complied with Private Companies Practice Section (PCPS) or Securities and Exchange Commission Practice Section (SECPS) CPE requirements.

Practice Tip:

If your firm lacks the necessary experience or knowledge to perform a particular assignment, it has three options: (1) obtain the knowledge through CPE or consultations, (2) hire someone on a contract or hourly basis, or (3) decline the engagement. The authors believe that most firms will find it easiest to adopt the second option.

Acceptance and Continuance of Clients

12.220 Carefully investigate all financial statement clients, initially and on an on-going basis, in order to minimize the likelihood of associating with a client whose management or ownership lacks integrity. As part of your firm's quality control system, it should establish policies and procedures which reasonably ensure that the clients for whom the firm performs financial statement engagements possess the requisite management integrity. Also, be careful about accepting high-risk clients, such as financial institutions, employee benefits plans under ERISA, municipalities, oil and gas companies, companies in high technology industries, and broker/dealers.

12.221 Minimum Documentation Recommendations for Acceptance and Continuance of Clients.

The authors believe that it is advisable for your firm to document the important considerations with regard to decisions about whether to accept or reject prospective clients and to continue or cease to service an existing client. Thus, it is highly advisable to use acceptance and continuance forms for all new clients and, periodically, for all continuing clients.

Hiring

12.222 It is sometimes difficult for a small practice to find good people, a fact that makes it even more important to check out each job candidate closely. Your firm's hiring policies and procedures should reasonably ensure that it employs only those professional personnel who possess the skills and characteristics that enable them to perform their duties competently. Analyze resumes, obtain college transcripts, contact references, and, most important, be sure to document your investigation and your decisions.

12.223 Minimum Documentation Recommendations for Hiring. At a minimum, the authors believe that your firm's personnel files should contain the following documentation: an application, a resume, or a similar document.

Assigning Personnel to Engagements

12.224 Establish policies and procedures to provide reasonable assurance that persons who work on an engagement have the degree of technical training and proficiency required under the circumstances. This element is typically not a major problem area for most firms.

12.225 Minimum Documentation Recommendations for Assigning Personnel to Engagements. The authors highly recommend that you maintain careful documentation of your firm's scheduling process and evidence of partner approval of the staff assigned to each engagement.

Advancement

12.226 Each member of your firm's professional staff should always know what it will take to progress professionally in the firm, as well as the exact nature of his or her current duties and responsibilities. Your firm's advancement policies and procedures should reasonably ensure that the employees you select for advancement have the qualifications necessary to fulfill the responsibilities they will assume. You should evaluate each member of your professional staff at least annually.

12.227 Minimum Documentation Recommendations for Advancement. At a minimum, the authors recommend that your firm's personnel files include an annual evaluation form or memorandum.

Practice Tip:

The authors believe the best practice for all but the smallest firm is to define staff levels and duties in writing.

Inspection

12.228 Under normal circumstances, your firm will have a peer review once every three years. In the two interim years when your firm is not reviewed, you must be sure that its quality control system is still working properly. The inspection element addresses this need. Be sure to establish policies and procedures to provide reasonable assurance that your firm's policies and procedures relating to the eight other elements of quality control are being effectively applied. You may perform your own inspections "in house" or hire a qualified person or firm to perform this function for you.

12.229 Minimum Documentation Recommendations for Inspection. The authors recommend that, at a minimum, your firm's documentation should consist of memoranda summarizing:

- The inspection scope and findings *and*
- The actions taken on those findings.

12.230 The AICPA's inspection materials are contained in the *AICPA Peer Review Program Manual*.

12.300 SUMMARY

12.301 Documentation is the key for most firms, the one element that often makes or breaks their peer review. Although the AICPA has *not* established minimum levels of documentation for your firm's quality control system, the authors believe that you should, at a minimum, carefully consider the documentation recommendations discussed in this chapter. They are summarized below (and recapitulated as a checklist in section 12.403).

12.302

Quality Control Element

Recommended Minimum Documentation

- | | |
|-----------------|--|
| 1. Independence | a. Annual written representations;
b. Memoranda of inquiry; <i>and</i>
c. Written representations from other auditors. |
| 2. Consultation | a. Documentation of consultations and conclusions; <i>and</i>
b. Access to an adequate reference library. |

<u>Quality Control Element</u>	<u>Recommended Minimum Documentation</u>
3. Supervision	<ul style="list-style-type: none"> a. Documentation of engagement partner's review; b. Engagement planning documentation; c. On audits, documentation of the understanding of internal control structure; d. On audits and reviews, documentation of analytical procedures; e. Documentation of evaluation of "going concern" considerations; f. Documentation of risk assessment; g. Documentation of materiality considerations; h. Written engagement program; i. Items that are required by generally accepted auditing standards, e.g., lawyer's letters; j. On audits and reviews, management representation letters, <i>and</i> k. Consideration of recent technical pronouncements.
<div style="border: 1px solid black; padding: 10px;"> <p>Practice Tip:</p> <p>Written policies and procedures are crucial to compliance with the supervision element.</p> </div>	
4. Professional Development	<ul style="list-style-type: none"> a. Documentation of compliance with AICPA and state CPE requirements and, if applicable, with PCPS or SECPS membership requirements <i>and</i> b. Documentation that the firm's CPE program fulfills the accounting and auditing needs of the firm's personnel.
5. Acceptance and Continuance of Clients	<ul style="list-style-type: none"> a. Acceptance and continuance form.
6. Hiring	<ul style="list-style-type: none"> a. Personnel files containing an application, resume, or a similar document.
7. Assigning Personnel to Engagements	<ul style="list-style-type: none"> a. Documentation of your firm's scheduling process <i>and</i> b. Documentation of partner approval of staff assigned to each engagement.
8. Advancement	<ul style="list-style-type: none"> a. Annual personnel evaluation forms or memoranda.
9. Inspection	<ul style="list-style-type: none"> a. Annual summary memoranda of scope of inspection, findings, and actions taken.

Practice Tip:

Always remember that the recommendations in this chapter reflect the authors' suggestions for documentation levels for a firm, and that while they are important to maintaining your firm's quality controls, most are *not* specifically required by the AICPA's professional standards. They may not necessarily be appropriate to your own practice, without at least some fine tuning. Chapters 3 through 11 provide you with more detailed information about each of the nine elements of quality control.

12.400 SAMPLE DOCUMENTATION

12.401 The authors have made minimum documentation recommendations for each of the nine elements of quality control. Failure to comply with similar recommendations has frequently caused problems in peer reviews.

12.402 The checklist in section 12.403 is provided to assist you in reviewing your firm's quality control system to ensure that it satisfies these recommendations for documentation for a small practice.

Practice Tip:

The low level of documentation contained in section 12.403 is not necessarily appropriate for your own practice, at least not without some fine tuning. Chapters 3 through 11 provide you with more detailed information about each of the nine elements of quality control.

Compliance Checklist on Minimum Documentation Recommendations

12.403 To ensure that your firm has reasonable documentation procedures for compliance with key quality control elements for which such standards exist, complete the steps indicated below. (*These are only recommendations—tailor your documentation to your firm's specific needs.*)

Prepared by: _____ Date: _____

Reviewed by: _____ Date: _____

	<u>Done</u>	<u>N/A</u>
1. Ensure that you have documentation of compliance with the <i>independence</i> element by requiring:		
a) Annual written representations.	_____	_____
b) Memoranda of inquiry.	_____	_____
c) Written representations from other auditors, if any.	_____	_____
2. Ensure that you have documentation of compliance with the <i>consultation</i> element by requiring:		
a) Documentation of all necessary consultations and the conclusions reached.	_____	_____
b) Access to an adequate reference library.	_____	_____
3. Ensure that you have documentation of compliance with the <i>supervision</i> element by requiring documentation of items such as:		
a) Engagement partner's review of work performed.	_____	_____
b) Engagement planning documentation.	_____	_____
c) Documentation of understanding of internal control structure on each audit engagement.	_____	_____
d) Documentation of analytical procedures in audits and reviews.	_____	_____
e) Documentation of evaluation of "going concern" considerations.	_____	_____
f) Documentation of risk assessment.	_____	_____
g) Documentation of consideration of materiality.	_____	_____
h) An engagement program.	_____	_____
i) All items required by generally accepted auditing standards, e.g., timely dated lawyer's letters.	_____	_____
j) Management representation letter.	_____	_____
k) Consideration of technical pronouncements.	_____	_____



	<u>Done</u>	<u>N/A</u>
4. Ensure that you have documentation of compliance with the <i>professional development</i> element by requiring:		
a) Documentation of compliance with AICPA and state CPE requirements.	_____	_____
b) If applicable, documentation of compliance with PCPS or SECPS requirements.	_____	_____
c) Documentation that the firm's CPE plan fulfills the accounting and auditing needs of the firm's personnel.	_____	_____
5. Ensure that you have documentation of <i>Client Acceptance and Continuance</i> considerations and conclusions.	_____	_____
6. Ensure that you have documentation of compliance with the <i>hiring</i> element by requiring that your personnel files contain an application, resume, or similar document for each staff member.	_____	_____
7. Ensure that you have documentation of compliance with the <i>Assigning Personnel to Engagements</i> element by requiring:		
a) Documentation of your scheduling process.	_____	_____
b) Documentation of partner approval of staff assigned to each engagement.	_____	_____
8. Ensure that you have documentation of compliance with the <i>advancement</i> element by requiring that your personnel files contain annual personnel evaluation forms or memoranda.	_____	_____
9. Ensure that you have documentation of compliance with the <i>inspection</i> element by requiring annual summary memoranda of scope of inspection, findings, and actions taken.	_____	_____

CHAPTER 13

ON-SITE PEER REVIEWS

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CHAPTER 13

ON-SITE PEER REVIEWS

13.000 OVERVIEW

13.001 If your firm performs any audits (or examinations of forecasts or projections), it has an audit practice. If it has an audit practice, and you and the members of your staff want to remain American Institute of Certified Public Accountants (AICPA) members, your firm must have an on-site peer review. The *number* of audits or examinations your firm performs is of no consequence in determining whether it has an audit practice. If it performs *any* audits or examinations — *even one* — it has an audit practice, and it must have an on-site peer review. Even if your firm performs one audit for *free* (for example, as a charitable donation), it has an audit practice.

Practice Tip:

Certain sole practitioners may qualify for a special type of "on-site" peer review in which they send their working paper files to the reviewer, instead of having the reviewer come to the firm. If your firm belongs to the PCPS or is enrolled in the AICPA Peer Review Program, and you are a sole practitioner with four or fewer professional staff, you may elect to have this type of review. While this type of review is acceptable to the AICPA, it may not be acceptable to certain state boards of accountancy. In general, the authors do not recommend the off-site "on-site" approach because they have found the cost savings usually to be small or nonexistent.

13.002 Your firm's on-site peer review will be designed to result in the expression of an opinion about whether, during the year under review:

1. Your firm's quality control system for its accounting and auditing practice met established quality control standards, *and*
2. Your firm was complying with its quality control policies and procedures.

Peer reviews of PCPS and SECPS member firms also result in an opinion regarding the firm's compliance with the section's membership requirements.

13.003 Your goal should be not only to pass your review but also to learn something from it while minimizing the costs. To accomplish this you must:

- Design and implement your firm's quality control system;

- Decide on the "right" program in which to enroll;
- Choose the type of review team that is best for your firm;
- Arrange for, prepare for, and expedite your firm's peer review;
- Understand and participate productively and effectively in the on-site or field work phase; *and*
- Understand and deal productively and effectively with the report and evaluation process that results.

Practice Tip:

Remember that the peer review process actually begins *months* before your firm's review team arrives. It includes an exchange of information about your firm. Start developing necessary information early, so that you will have reliable data available when you schedule your firm's review.

Review Phases

13.004 Regardless of the type of peer review, and regardless of how you select your firm's review team, an on-site peer review consists of three phases:

1. Planning,
2. Field work, *and*
3. Report and acceptance.

Practice Tip:

You may find it helpful to think of a peer review as an audit. The *planning phase* is quite similar to the planning you would do if you were preparing to audit one of your firm's clients. Similarly, the *field work* is the visible part of the engagement, the part of which the client (your firm, in this case) is most aware. Finally, the *report and acceptance* phase is analogous to the work you would do to issue your client's report, including not only writing the report but also following your internal quality assurance procedures.

13.005 Planning. During the planning phase, your firm's peer review team captain will study the information you provide in order to be ready to conduct a comprehensive but efficient review upon arrival at your office. This phase also includes routine administrative matters, such as your signing of an engagement letter.

13.006 Field Work. The field work is the part of the peer review you actually "see" while the review is being conducted in your office. It entails review of engagements, inquiries of firm personnel,

inspection of certain documents, and observation of your firm's reference library. Field work ends with the exit conference when you and other senior members of your firm are informed about any matters that may affect the review report and about all significant findings and recommendations that will be included in the letter of comments.

13.007 Report and Acceptance. The report and acceptance phase often begins in your office and may be continued after your firm's peer reviewers leave the field. Acceptance by your firm's administering entity, of course, occurs away from your office at a later date.

Scope and Cost of On-Site Peer Reviews: An Overview

13.008 Whether your firm has a review under the AICPA Peer Review Program or has an SECPS review may affect the cost. Because there is a little more to do, and because the reviewers' hourly rates are generally higher, SECPS peer reviews may be a bit more expensive than PRP reviews. Your choice about whether a Committee-Appointed Review Team (CART), another firm (firm-on-firm), or an association team will conduct your firm's review may also have some effect. However, in making your choices you should understand some fundamental principles about the cost and scope of your firm's peer review.

13.009 The cost of your firm's peer review will, of course, be a function of the time it takes to conduct the review and any travel costs that the peer review team incurs.

13.010 What Review Hours Encompass. For reviews of PCPS and PRP firms, your firm's peer review team is expected to review certain high-risk engagements and at least 5% to 10% of your firm's total accounting and auditing engagements. The review team's total time includes not only the time necessary to review the engagements, but also the time necessary for review of the functional quality control elements and for planning, administration, and report writing. One very rough (and definitely unofficial) rule of thumb used by some reviewers is that engagement reviews might approximate .00375 of a firm's annual accounting and auditing hours, and that the other parts of the review might require an additional 10-20 hours for firms with up to 20 professionals. Because it is difficult to achieve an appropriate cross-section of a small firm's practice without actually reviewing more than 5% to 10% of its engagements, proportionately more engagement review time is likely to be spent on a small practice's peer review. See also the general guidelines at section 13.809.

13.011 Standards for selecting engagements are different for SECPS peer reviews. SECPS guidelines set no minimum percentage of accounting and auditing hours but rather requires a "risk-based" approach to engagement selection. This approach focuses on an assessment of the inherent and control risks associated with a reviewed firm's accounting and auditing practice and quality control system, including consideration of the extent of clients in high risk and regulated industries.

13.012 In addition to the above factors, the total cost of the review will certainly be affected by the ease with which your firm's peer review team can obtain information directly from your workpapers (without the need for extended oral inquiries and conversations) and by the number of issues, if any, that need to be discussed and resolved. The authors have seen some seemingly simple reviews of small firms cost considerably more than reviews of somewhat larger practices, simply because the workpapers were inadequate or difficult to follow or because lengthy letters of comments had to be written regarding numerous or significant issues disclosed by the review.

13.013 If your practice is small (generally under 10,000 accounting and auditing hours), your firm's peer review team will usually consist of one person (who will be called the "team captain"). Even though you may see this person in your office for only one or two days, the final bill probably will include additional hours. This is because the team captain will usually spend several hours, at a minimum, on administrative and planning matters before arriving at your office and several more hours finalizing the review work papers and writing reports after leaving the field. Such behind-the-scenes activities commonly add as much as a day's time to a peer review.

13.100 DESIGNING AND IMPLEMENTING YOUR FIRM'S QUALITY CONTROL SYSTEM

13.101 Your real key to success in your firm's on-site peer review is the proper design and implementation of an effective quality control system. If your firm does not have its system in place yet and you are simply reading ahead to learn about the peer review process, be sure to study Chapter 2 for an overview of what your firm's quality control system should include, as well as Chapters 3 through 11 for specific details and Chapter 12 for a summary of documentation recommendations and other compliance considerations.

13.102 It is extremely important to ensure that the quality control system you design fits *your* firm's practice and that the firm can, and does, comply with it.

Who Defines Quality?

13.103 One of the questions asked most frequently by practitioners who are facing a peer review is: "Who defines quality?" This question is often followed by another: "Will I fail my review if I don't fill out a lot of forms that I don't consider necessary in my practice?"

13.104 There are no standard answers that fit all situations. As discussed in this Manual, quality is a rather elusive and subjective concept when it is applied to a professional situation involving experience and judgment (see Chapters 1–2). Accordingly, your firm's peer review team will evaluate your firm's quality control system in terms of general standards for the profession, as adapted to your firm's specific circumstances. Your firm will not "fail" its peer review solely because it chose to omit certain forms or procedures, as long as either (1) the procedures would not have been applicable or (2) other factors related to the size and nature of the practice mitigate their omission. The authors believe that, if you follow the guidance in this Manual and do professionally competent work, your firm should not have much to worry about. See also the discussion of minimum documentation recommendations in Chapter 12.

13.105 A peer review team will probably consider a relatively small firm's quality control system adequate if no significant or pervasive deficiencies are found in the engagements reviewed, even if the system itself is extremely informal. In other words, the emphasis will be on the real objective of a quality control system — compliance with professional standards.

13.200 SELECTING THE "RIGHT" PROGRAM IN WHICH TO ENROLL

13.201 If you and the members of your staff want to remain affiliated with the AICPA, and if your firm performs *any* audits, your firm must be associated with one of the AICPA-approved practice monitoring programs. That requirement can be satisfied by being a member of the:

1. AICPA Peer Review Program (PRP), *or*
2. Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms (PCPS peer reviews are administered under the AICPA Peer Review Program), *or*
3. SEC Practice Section (SECPS) of the AICPA Division for CPA Firms.

Administering Entity

13.202 Most on-site peer reviews are conducted under the standards of the AICPA Peer Review Program. If you and your associates are members of the AICPA, your firm *must* enroll in the AICPA Peer Review Program unless it joins the PCPS or SECPS of the AICPA's Division for CPA Firms.

13.203 If your firm is a member of the PCPS or enrolled in the AICPA Peer Review Program, your own state CPA society will administer your review locally. If your state society does administer reviews, contact your society for further information. If your state society has elected not to administer reviews, it will refer you to another state society. For instance, the Texas Society of CPAs will administer peer reviews of CPA firms in Utah as well as Texas.

13.204 SECPS continues to administer its own peer review program through the AICPA Peer Review Division.

13.205 If your firm belongs to the SECPS, it must have an SECPS peer review; this review will also satisfy all PCPS and mandatory AICPA practice monitoring requirements as well. Similarly, if your firm belongs to the PCPS, its PRP peer review will satisfy all AICPA membership requirements.

13.206 Note that a firm must join the SECPS, and have an SECPS peer review, if it has *any* SEC clients.

Scope of Peer Review

13.207 The scope of your firm's peer review will depend on the number of professionals in the firm, the number of accounting and auditing hours, as well as on the program in which your firm is enrolled.

13.208 For peer review purposes, a "professional" is not necessarily a CPA. Instead, a professional is generally any employee who is a CPA or who is expected to attain that designation during his or her career.

On-Site Peer Reviews

13.209 If your firm has more than 10 professionals, its on-site peer review will always cover all nine elements of quality control:

1. Independence (Chapter 3),
2. Consultation (Chapter 4),
3. Supervision (Chapter 5),

4. Professional development (Chapter 6),
5. Acceptance and continuance of clients (Chapter 7),
6. Hiring (Chapter 8),
7. Assigning of personnel to engagements (Chapter 9),
8. Advancement (Chapter 10), *and*
9. Inspection (Chapter 11).

13.210 If your firm is a PCPS member or is enrolled in the AICPA Peer Review Program and has 10 or fewer professionals, its peer review will *focus* on four key quality control elements:

1. Independence,
2. Consultation,
3. Supervision, *and*
4. Professional development.

13.211 However, your firm's peer review team is not precluded from reviewing some or all of the remaining five quality control elements if it deems such review to be appropriate.

PCPS Peer Reviews

13.212 In addition to focusing on the quality control elements, a PCPS firm's review will cover compliance with PCPS membership requirements.

SECPS Peer Reviews

13.213 If your firm has any SEC clients, it must join the SECPS. Although similar to reviews of PCPS and PRP firms, your firm's SECPS peer review will also cover compliance with SECPS membership requirements and certain specific items that are applicable only to publicly held SEC clients. Examples of some of the key membership requirements of the SECPS are:

- A second partner concurring review of the audit report and financial statements for SEC engagements,
- Partner rotation on SEC engagements after seven consecutive years (unless you have both (a) fewer than five SEC clients *and* (b) fewer than 10 partners),
- A written statement of firm philosophy, *and*

- Reporting annually to the audit committee or board of directors of each SEC client about management advisory services performed and disagreements with management about auditing, accounting, or disclosure matters.

13.214 If your firm has 10 or fewer professionals, your SECPS peer review will ordinarily focus on six of the nine quality control elements:

1. Independence,
2. Consultation,
3. Supervision,
4. Professional development,
5. Acceptance and continuance of clients, *and*
6. Inspection.

**Is an SECPS Peer Review Harder to Pass
Than a Review Performed Under the AICPA
Peer Review Program?**

13.215 Conceptually, an SECPS peer review is slightly more encompassing than a peer review under the AICPA Peer Review Program. In practice, however, a firm would be hard-pressed to actually notice any real differences in the conduct of the two types of reviews (other than the more stringent membership requirements of the SECPS).

Cost Considerations

13.216 Reviews of PCPS and PRP firms generally cost slightly less than an SECPS peer review. Recent cost statistics are shown in section 13.802.

13.300 CHOOSING THE BEST TYPE OF REVIEW TEAM FOR YOUR PRACTICE

13.301 Three types of review teams can perform your firm's review under the AICPA Peer Review Program or the SECPS Peer Review Program (see also Chapter 1):

1. A Committee-Appointed Review Team (CART),
2. A firm-on-firm review team, *or*
3. An association of CPA firms review team.

13.302 There is no right or wrong way to select your review team. Most early reviews were conducted by CARTs. Today, most are firm-on-firm reviews. The major comparative factors are summarized below, but you might also want to glance at the discussion of the approval process beginning in section 13.534 before making your decision.

Practice Tip:

You may eventually want to conduct reviews of other CPA firms. Acting as a reviewer is usually an educational experience for the reviewer as well as for the reviewed firm. In addition, it can help you turn idle summer and fall time into chargeable hours. Besides the obvious educational and monetary benefits, reviewing other CPA firms adds to your prestige and credibility.

If you want to perform reviews of other firms, you should contact the AICPA for the forms that you must complete and submit in order to be added to the AICPA's data bank reviewers or to have your firm listed in the data bank for firm-on-firm reviews.

Team captain qualifications are stricter than review team member requirements. To be a team captain, you *must* complete the AICPA's training course on how to conduct a peer review, and you *must* be currently active in accounting and auditing. To continue as a team captain, a reviewer must have completed an AICPA approved reviewer's training course within five years of the start of a review.

CARTs

13.303 Depending upon the type of review, either the SECPS or a state CPA society will appoint the CART.

13.304 PCPS and PRP Firms CART. If your firm desires a CART-conducted peer review, contact your administering entity (usually your own state CPA society). The administering entity will use the AICPA's computer system to assign a review team that possesses the proper mix of industry specializations and skills to match the firm profile that you will be submitting about your practice.

13.305 SECPS CART. If your SECPS member firm desires a CART-conducted SECPS peer review, contact the AICPA Peer Review Division in New Jersey. The AICPA will select your review team, taking into account your firm's industry specializations.

Firm-on-Firm Review Teams

13.306 Most CPA firms choose to hire another CPA firm to conduct their peer reviews, rather than requesting a CART review. One advantage is that you will know (or can find out about) the background, philosophy, and capabilities of the reviewing firm you choose before you engage it.

Qualifications for Conducting Peer Reviews

13.307 The team captain (and other members, if any, of the review team) must be included in the AICPA's reviewer bank. The entity that administers your firm's peer review will confirm your proposed reviewers' qualifications with the information in the AICPA reviewer bank before scheduling the review. If your firm belongs to the PCPS or SECPS, see also sections 13.311 or 13.312, respectively.

13.308 According to the AICPA's *Standards for Performing and Reporting on Peer Reviews*, for reviews of PCPS and PRP firms, a review team member must be:

1. An AICPA member,
2. Licensed as a CPA,
3. In possession of current knowledge of applicable professional standards,
4. Currently active at a supervisory level (partner, shareholder, proprietor, manager, or equivalent supervisory responsibilities) in the accounting or auditing function of a CPA firm that is enrolled in the AICPA's Peer Review Program or the Division for CPA Firms, *and*
5. At least five years of recent experience in accounting and auditing.

13.309 In addition, a team captain must:

1. Be a partner, shareholder, or proprietor of an enrolled firm;
2. Have completed an AICPA-approved training course in conducting peer reviews within five years from the start of the review (the pre-1990 course on quality reviews alone will not suffice); *and*
3. Be associated with a firm that has received an unqualified report on its quality control system within the previous three years.

13.310 A team captain cannot serve in that capacity for more than two successive peer reviews of the same firm.

Additional Qualifications for Conducting PCPS Reviews of Firms

13.311 For PCPS firms, in addition to the above, the persons on the team must come from firms that are themselves members of the PCPS, and they must have received an unqualified report on their own most recent peer review.

Qualifications for Conducting SECPS Peer Reviews

13.312 Persons serving on an SECPS peer review team must be affiliated with firms that are members of the SECPS. All other qualifications are the same as those for PCPS and PRP firms, except that the SECPS does not specifically require five years of experience in accounting and auditing and the SECPS permits a team captain to conduct three successive SECPS peer reviews of a firm.

Association Review Team

13.313 An association of CPA firms may be authorized to arrange and carry out peer reviews in a manner similar to firm-on-firm reviews.

Association Peer Review Team — PRP and PCPS Firms

13.314 If your firm is a member of the PCPS or is enrolled in the PRP and belongs to a CPA association that has received authorization to conduct peer reviews, your firm may elect to have its peer review performed by a review team appointed by that association, under the supervision of the state CPA society

administering your firm's review. Qualifications of review team members and captains are the same as for firm-on-firm peer reviews.

Association Peer Review Team — SECPS Firms

13.315 Subject to certain guidelines published and monitored by the SECPS, if your SECPS firm belongs to a CPA association that qualifies, your firm may elect to have a review team appointed and administered by the CPA association conduct its SECPS peer review under the supervision of the AICPA Peer Review Division. Qualifications of review team members and captains are essentially the same as for firm-on-firm peer reviews.

Cost Considerations

13.316 Firm-on-firm peer reviews and CART peer reviews are usually similar in cost. However, some differences between those two types of reviews include:

1. The price of a firm-on-firm review is negotiated *and*
2. Firm-on-firm team members are already accustomed to working together.

SECPS Peer Review Acceptance Fees

13.317 After April 3, 1995, SECPS member firms will be assessed peer review acceptance fees, based on firm size, as follows:

<u>Size of Firm</u>	<u>Acceptance Fee</u>
1 to 10 professionals	\$ 350
11 to 20 professionals	\$ 650
More than 20 professionals	\$1,100

13.318 Each state society that has elected to administer reviews of PCPS and PRP firms under the AICPA Peer Review Program sets its own CART fee structure. Check with the state society administering your review for details, but do expect some charge to be levied. Reviews of PCPS and PRP firms in states that have not elected full involvement (Alaska, Arizona, the District of Columbia, Guam, Hawaii, Nebraska, South Dakota, Utah, the Virgin Islands, and Wyoming), will be administered by another state society.

Some state societies use a formula such as the following to set administrative fees:

<u>Size of Firm</u>	<u>Annual Fee</u>	<u>Scheduling Fee</u>	<u>Evaluation Fee</u>
Sole proprietor with no professional staff	\$ 50	\$ 50	\$150
2 to 10 professionals	\$ 75	\$100	\$150
More than 10 professionals	\$100	\$150	\$250

Negotiated Price

13.319 CART peer reviews are conducted at hourly rates that the various administering entities periodically set.

13.320 In contrast, the cost of a firm-on-firm review is somewhat negotiable. Your firm may solicit bids from several firms. Most reviewing firms base their quotes on peer review rates which, in most cases, are already substantially below the firms' standard rates.

Established Team

13.321 Multi-person firm-on-firm teams are likely to be more efficient than CART teams because members of the same firm are already accustomed to working with each other and they may have conducted reviews together before.

Other Cost Considerations

13.322 With a firm-on-firm review, your firm usually can avoid or reduce travel costs by selecting a review team from your own city or one that is nearby. If you can live with the idea that a nearby practitioner will scrutinize your firm's work, you can certainly save on transportation costs and hotel bills.

13.323 For CART reviews, whenever possible, the AICPA computer selects review team members from the same state but *not* the same postal zip code as the reviewed firm. If your firm decides to have a CART peer review, you can specify which zip codes are preferable to you as well as any additional zip codes that are unacceptable. Thus, you can minimize travel expenses even if your firm decides to have a CART peer review.

Matching of Reviewer and Reviewed Firm

13.324 If your firm elects to have a CART review, its administering state CPA society or for SECPS reviews the AICPA Peer Review Division will assign an appropriate review team, matching the review team's qualifications to your firm's needs. If, on the other hand, your firm engages another CPA firm (or possibly its CPA association) to conduct its review, you can to some extent handpick a review team with a practice philosophy similar to your own — one on which you can count for a full understanding of your practice. You can also gain invaluable insight by choosing a team that you respect from a technical or administrative standpoint and one that is willing to share with you, during the course of your firm's review, some practice management comments and observations that you know will be geared to your type and size of practice.

13.325 The right match can also make your firm's peer review far more efficient. A firm-on-firm review is just as effective as a CART review, and can sometimes be completed more swiftly if you choose a review team that you know has an understanding and appreciation of your firm's size and the way you practice.

13.400 PREPARING FOR AND EXPEDITING YOUR FIRM'S PEER REVIEW

13.401 Once you have decided on which program to enroll and which type of review team to use, *you* will have to take affirmative steps to prepare for and expedite your firm's review. You must:

1. Schedule your firm's peer review and, if appropriate, select and engage your review team;
2. Select a proper peer review year;
3. Assemble necessary information;
4. Become familiar with the forms and checklists your firm's peer review team will be using;
and
5. See to logistics and related concerns.

Practice Tip:

The SECPS Peer Review Program and the AICPA Peer Review Program Manuals include planning checklists and instructions to firms. You might use these materials to make your planning process as complete and error-free as possible. Their contents are also covered in this chapter. Once your firm's reviewer or review team arrives, do your best to ensure that the peer review will be efficient and meaningful.

Review Team Selection and Scheduling of Review

13.402 If you decide to use a firm or an association review team, your first step is to select your firm's peer review team.

13.403 Even if your firm does not belong to the PCPS, the PCPS's *Firm-on-Firm Review Directory* (product no. 820004) is a good starting point if you do not already have any firms in mind. This directory will help you to locate firms of the right size and in the desired geographic area, and it will help you find a firm with industry concentrations similar to your own. Of course, other qualified firms exist that are not in the directory. You may want to consult with your state CPA society for a list of qualified firms in your area. The firm you choose must, of course, be independent of your firm; reciprocal reviews are not permitted.

13.404 To arrange a peer review of a PCPS or PRP firm, submit a scheduling form to the entity that administers peer reviews for your state. Contact your own state CPA society for further information. You can also contact the AICPA's Peer Review Division at (201) 938-3030 for information.

13.405 To arrange a SECPS peer review, contact the AICPA Peer Review Division at (201) 938-3030.

13.406 If you have scheduled a firm-on-firm review, your firm's administering entity will satisfy itself that the review team is appropriately qualified to perform your firm's peer review and that its industry concentrations appear to be a good match with those of your firm. You will be contacted if any questions arise.

13.407 If you have requested a CART review, your firm's administering entity will notify you of the personnel selected for the review team, and you will have the opportunity to reject anyone whom you want to exclude from reviewing your practice.

Planning Summary

13.408 To keep your firm's costs down, consider the following:

- Select a reviewing firm that is experienced in conducting peer reviews;
- Firm-on-firm reviews sometimes cost slightly less than CART reviews; *and*
- Minimize travel costs by selecting a nearby firm to conduct a firm-on-firm review.

13.409 In addition, the authors recommend that you keep these points in mind for a firm-on-firm review:

- Select a review team that can teach you something;
- Choose a firm that has already reached the size your firm would like to attain;
- Choose a firm known for its overall high quality;
- Choose a firm that is knowledgeable about your firm's industry concentrations; *and*
- Choose a firm with philosophies that are compatible with yours.

Engagement Letter

13.410 If you request a CART review, the entity administering your firm's review will send you an engagement letter for your signature. This letter will specify:

1. Who will serve on your firm's peer review team;
2. What range of hours is expected at standard CART rates;
3. What the expense reimbursement policy is;
4. Whether your firm must obtain clients' permission to have workpapers reviewed;
5. That review team members will not have any client contact; *and*
6. That your firm will not seek to hold its review team liable for damages on account of any good faith act or omission nor subpoena them to testify on engagements reviewed.

13.411 If you engage another CPA firm to perform your firm's peer review, or engage an association of CPA firms, the review team will probably send you a similar engagement letter to confirm your mutual understanding of the engagement.

Selection of Proper "Review Year" (Period Review Will Cover)

13.412 Your firm's peer review year is not necessarily its fiscal year. Rather, it is a current 12-month period that you and your review team captain will mutually select. Depending on the nature of your practice, your firm's review will normally occur between 60 and 120 days after the end of your agreed-upon peer review year.

Practice Tip:

A poorly chosen peer review year can result in wasted time during your firm's review if the year causes confusion or concern about whether the review is providing appropriate coverage of your current practice.

Determination of Engagements Falling Within Review Year

13.413 Engagements selected for review are those with fiscal year-ends (or interim periods) that fall within your firm's peer review year. This determination is made according to your firm's *clients'* accounting periods, not on the basis of when you actually performed the work. Accordingly, choose a peer review year that includes your firm's current significant clients and that is sufficiently in advance of the peer review fieldwork to ensure that all work has been completed and that the clients' financial statements and related reports have been issued.

Practice Tip:

Your firm's peer review year generally should not end earlier than December 31 of the year preceding your review. Be aware, however, that the peer review team may select an engagement completed subsequent to your firm's review year if that engagement pertains to a client selected for review.

Assembling Information

13.414 Your information-gathering obligation starts when you prepare to schedule your firm's peer review and continues throughout the review process.

Background Information to Assemble

13.415 You will need to prepare a firm profile for use by your firm's review team and administering entity. It must include information regarding the number of audits, reviews, compilations, and prospective financial statement engagements that your firm performs annually and the approximate number of total accounting and auditing hours for each of these categories. In addition, you must specify

your firm's industry concentrations. Industry concentrations are those industries representing 10% or more of your firm's accounting and auditing hours. Such information is not only necessary for approval of the review team, but also your firm's peer review team captain will use this profile during the initial planning phase of the peer review.

Client List

13.416 Closer to your firm's peer review fieldwork date, the team captain will request a client list, which will be used for selecting specific engagements for review. The list you provide does not have to identify your firm's clients by name. Instead, if you wish, you may use client numbers or some sort of code. Your list should include annualized information as of a fiscal year-end upon which you and your team captain mutually agree.

13.417 Your firm's client list should give the following information about each client:

1. Client's year end,
2. Nature of engagement (audit, review, compilation, and so forth),
3. Client's industry,
4. Total *accounting and auditing* hours for engagement,
5. Engagement partner,
6. Accountant in charge of field work,
7. Whether the client is a new client,
8. Whether the client is publicly held,
9. Whether the client is covered by the Single Audit Act of 1984 or *Government Auditing Standards*, and
10. Whether the client is covered by ERISA.

13.418 Your firm's peer review team captain will use this information to select clients that represent a cross section of your firm's accounting and auditing practice. In addition, the team captain will select clients of significant public interest and new clients (to test your firm's client acceptance procedures).

Additional Information

13.419 In addition to your firm's profile and client list, submit the following information to the peer review team captain during the planning stage of the review:

1. An AICPA quality control policies and procedures questionnaire (from the *AICPA Peer Review Program Manual*) or, for SECPS firms from the *SECPS Peer Review Program Manual* plus your firm's own expanded quality control document (as discussed in Chapters 3–11), if it has one (not required);
2. Copies of your firm's own checklists, programs, manuals, and the like;

3. Your firm's most recent inspection summary reports; *and*
4. Other relevant information, such as personnel lists showing departmental responsibilities (audit, tax, or management consulting services) and whether certified.

Practice Tip:

You can help your firm's peer review team captain plan an efficient review by providing additional background information before the review team visits your office. This information might include your firm's brochures, personnel manuals, policy manuals, and quality control document or questionnaire. A description of each partner's background and abilities is also helpful in the planning process.

Like an audit, the better your firm's peer review is planned, the fewer the hours that will be spent in the field. Planning is particularly important if your firm's reviewers are from out of town; it could save an extra night's hotel bill.

Accounting and Auditing Hours

13.420 As previously explained, the cost of your firm's peer review will be a function of the time it takes to conduct the review and the travel costs, if any, that the peer review team incurs. The time that it takes to conduct the review is a function of your firm's accounting and auditing hours, and you will have to provide the review team with a breakdown of both total and per client accounting and auditing hours. The peer review team will review a minimum of 5% to 10% of your firm's total accounting and auditing hours. However, it is usually necessary to exceed this range to obtain a reasonable cross section of a small firm's practice.

13.421 When summarizing your firm's interim engagements, consider each report issued during the year to be a separate engagement. Thus, for example, you would list a monthly compilation that takes four hours each month as 12 engagements totalling 48 hours.

Practice Tip:

You may find it difficult to arrive at your firm's total accounting and auditing hours, and you may have to resort to reasonable estimation. Most firms do this by estimating their tax, bookkeeping, and management consulting service hours for each financial statement client and deducting those hours from the total hours to approximate the accounting and auditing hours.

Other Information Needs You Should Anticipate

13.422 Do *not* make your firm's peer review team wait around while you search for information or documents. The team captain will probably call you a few days before the review fieldwork to identify

some of the engagements selected, which will enable you to pull all related client files. Everything should be ready when the review team walks through your firm's front door.

13.423 To keep an element of surprise, some additional engagements are selected in the field. When additional engagements are selected, start assembling all related files immediately, so that they will be available to the review team as soon as they are needed.

Practice Tip:

You may be tempted to scrutinize the engagements selected in advance and to fix problems in your firm's workpaper files. Do *not* succumb. First of all, you will negate the whole point of having the peer review — that is, to have an evaluation of the effectiveness of your firm's ongoing system of quality control. Secondly, it may complicate your firm's review. It will look extremely suspicious if the quality of the field-selected files is not consistent with that of the preselected files.

13.424 In anticipating the needs of your firm's peer review team, be sure to have reference materials and firm documents handy. If your firm belongs to the PCPS or the SECPS, have membership documents ready for review (that is, evidence of AICPA membership, copy of annual report to the Division for CPA Firms, and canceled checks evidencing dues payments to the AICPA). Also, if applicable, have your firm's annual independence confirmations readily available and be sure that all CPE documentation is up to date and available for review.

Practice Tip:

Make sure that supplying any items your firm's peer review team requests is treated as a top priority. Some firms assign a specific person to work with the review team.

Staff Interviews

13.425 The peer review team will need to interview one or more of your firm's professional staff members to see if the staff members are fully aware of the firm's quality control policies and procedures and to learn more about such policies and procedures.

Practice Tip:

It is a good idea to hold a staff CPE session a week or two before your firm's peer review to explain the purpose and nature of the review and what to expect. Emphasize that you expect everyone to cooperate fully and that some staff persons may be selected for candid interviews with the review team. This meeting would also provide an excellent opportunity to ensure that all personnel fully understand all of your firm's quality control policies and procedures.

Review of Reviewer's Forms and Checklists

13.426 One of the best ways to be prepared for your firm's peer review and ready to answer the reviewer's questions is to be thoroughly familiar with the forms and checklists that the reviewers will fill out during the peer review. You may already be somewhat familiar with these materials from your involvement in the internal inspection process, but you will find it helpful to take the time shortly before your firm's peer review to refresh your understanding. If your firm is a member of the SECPS, you can find all of the forms that will be used in the firm's SECPS peer review in your copy of the *SECPS Peer Review Program Manual*. If your firm is a member of the PCPS or is enrolled in the AICPA Peer Review Program, you can purchase the looseleaf *AICPA Peer Review Program Manual* from the AICPA for \$145 before June 1, 1995 or \$150 thereafter and enroll in its update subscription service; you can also buy a paperback version for \$75. Contact the AICPA order department at (800) 862-4272 (TO-AICPA).

Logistics and Other Details

13.427 Paying attention to a number of logistical details will enable you to make your firm's peer review a smooth one (and thus to minimize costs). So can using your common sense and generally facilitating the review team's task as much as possible.

13.428 In addition to the items discussed below, you may want to ask your firm's peer review team to try to draft its report letter and letter of comments, if time permits, before it leaves your firm's premises. In that case, you should make appropriate arrangements for the use of a computer or for typing support.

Review Team Liaison

13.429 The best practice is to appoint someone as review team liaison several months before your firm's peer review and to give this person appropriate authority to handle logistical details of the type described in the remainder of this section. This person should make most of the planning decisions for the peer review. Preferably, the person you designate should be the person responsible for your quality control system or a management-level designee under the close supervision of the managing partner, quality control partner, or proprietor.

Hotel Reservations

13.430 If your firm's peer review team members come from out of town, you will do them a favor if you make their hotel reservations. At the same time, you may be able to negotiate better rates than they would otherwise be able to obtain. Your firm will ultimately pay the bill, so you might as well do your best to minimize it.

Practice Tip:

Choose a comfortable hotel or motel that is appropriate for professionals traveling on business. The accommodations should be reasonably close to your office. On out of town assignments, many peer review team captains make sure they stay on schedule by doing some work in their hotel rooms at night. For this reason, it is helpful to select a hotel that provides well-lighted work areas in its rooms.

Transportation Arrangements

13.431 It is usually easier for each peer review team member coming from out of town to make his or her own transportation arrangements. However, you should take charge of local travel—be sure to tell the team captain whether you will be picking up the review team at the airport and at its hotel each morning, or whether the team should rent a car or use taxis.

Meals

13.432 The firm being reviewed generally pays for all meals for an out-of-town review team. The authors recommend that you, or your partners and key staff members, be available to take the review team to lunch each day. It is a good idea to take them to dinner, too. Some of the most candid and educational conversations take place during meals. The interaction also keeps the members of the review team in a positive frame of mind.

Work Space

13.433 Provide a large, quiet, well-lit work space in which your firm's peer review team can spread out. A private office or conference room where they will not be constantly interrupted or disturbed is ideal. Make your review team as comfortable as you would like to be if the situation were reversed.

Working Conditions

13.434 Do *not* allow anyone to distract the peer review team while it is trying to work. There is plenty of time for social conversation during meals or after hours. But during business hours you should not allow yourself, or your partners or staff, to distract the review team with lengthy or irrelevant conversations.

Temporary Work Permits

13.435 If your state requires temporary work permits for out-of-state CPAs, and any members of your firm's peer review team are not licensed in your own state, make sure that they obtain the necessary permits ahead of time. Some states still require work permits. To be safe, double-check your own state's current rules.

Review Timetable

13.436 Check with your firm's peer review team captain about the review timetable and honor all requests. Time is money. Allow the review team to do its job so that it can complete your firm's review efficiently and will have time to discuss its informal comments and observations with you. If your the team wants to start early, work late, or eat only a quick meal, be sure to accommodate it. After all, your mutual goal is the timely completion of your firm's review.

Rapport

13.437 It is important for you and your firm's peer review team to establish a good working relationship at the start of the review and to maintain it throughout. The review team must feel that it can trust you

and your firm, and you need to be comfortable about its competence and reasonableness. If you have any questions about the review process, ask the review team captain.

Practice Tip:

If the logistics permit, consider meeting your firm's peer review team for *breakfast* on the first morning of your firm's review. It is an excellent way for you to become acquainted with the review team — and to brief them about yourself, your firm's practice, and the business environment in which it operates.

Cooperation

13.438 Cooperate with your firm's peer review team at every step along the way. If you view team members as pains in the neck, they probably will be. But if you treat them as friends and fellow professionals, that is what they will probably turn out to be.

Honesty and Candor

13.439 Honesty is clearly the best policy. If something is not quite right, or if a document is missing, admit it. The worst thing you can do is to be untruthful or inappropriately argumentative; the peer review team needs to believe in the integrity of your practice.

13.500 YOUR FIRM'S PEER REVIEW: THE ON-SITE OR FIELD PHASE

13.501 In the field, your firm's peer review team will examine the firm's quality control system. To repeat what was stated at the beginning of this chapter, an on-site review is designed to result in the expression of an opinion about whether, during the year under review:

1. Your firm's quality control system for its accounting and auditing practice met established quality control standards, *and*
2. Your firm was complying with its quality control policies and procedures.

13.502 Depending on the size of your firm and the size of the peer review team, the review team will spend at least one day, and probably several, in your office evaluating your firm's systems and workpapers, interviewing your staff, and otherwise gathering information.

Engagement Selection

13.503 The background information that you assemble while you are preparing for your firm's peer review provides the key information that the review team captain will use to select engagements for review. Expect the team captain to choose engagements with clients in problem industries (that is, with high risk or complex situations) and those involving a public interest, such as financial institutions, municipalities, and clients that are subject to ERISA. If your firm has any SEC clients, it must join the

SECPS, and at least one SEC engagement will be selected for peer review. In addition, the SECPS requires engagement selection to be based upon a "risk-based" approach. Regardless of the type of peer review, if your firm's review is intended to meet the requirements of *Government Auditing Standards*, at least one engagement covered by those standards will be reviewed, normally one that comes under the Single Audit Act, if applicable.

Practice Tip:

Accountant/client privilege rules vary from state to state. It is your responsibility to find out whether statutes in your state or rules of your state board of accountancy provide a peer review exemption from confidentiality requirements. In some states, disclosure of client information to the peer review team is clearly exempt, but in other states, it may technically be necessary for you to obtain client permission. You may want to consult the entity administering your review, or your state board of accountancy, if you have any questions in this area. You may also want to consider advising your firm's clients that the accounting and auditing work performed on their account may be subject to peer review.

13.504 At least one new client, if applicable, will be selected so that the peer review team can test your firm's client acceptance practices. Emphasis will also be given to clients that are within your firm's industry concentrations or that represent more than 5% of your firm's total accounting and auditing hours.

13.505 To examine a cross section of your practice, your firm's peer review will cover the work of all or most partners who perform accounting and auditing engagements. Special consideration will be given to the work of any satellite or branch offices.

Practice Tip:

The engagements selected for review should have actually been issued prior to the commencement of the peer review fieldwork.

What Your Firm's Peer Review Team Will Examine

13.506 Your firm's peer review is not intended to be a witch-hunt. Simply put, the review team will be evaluating the effectiveness of your firm's quality control system, taking into account the size and nature of your practice. It will accomplish this goal by reviewing:

1. Compliance with functional areas, *and*
2. Engagement files.

13.507 In addition, you may receive a significant side benefit — practice management recommendations.

Compliance With Functional Areas

13.508 This portion of a peer review has two aspects. The first is evaluation of your firm's quality controls relating to the nine quality control elements specified in *Statement on Quality Control Standards No. 1* (SQCS No. 1). If your firm has 10 or fewer professionals, usually only four of the quality control elements will be emphasized: (1) Independence (Chapter 3), (2) consultation (Chapter 4), (3) supervision (Chapter 5), and (4) professional development (Chapter 6).

13.509 If your firm has 10 or fewer professionals and is an SECPS member, its peer review will ordinarily focus on six of the nine quality control elements. These will be the four elements in the preceding paragraph plus (5) inspection and (6) acceptance and continuance of clients.

13.510 The second aspect of this portion of a peer review tests your firm's *compliance* with its quality control system. If you were performing similar procedures in an audit, you would first learn about your client's internal control structure and then perform your test of controls to satisfy yourself that your client was indeed following its system. This process is, in effect, what your firm's peer review team will be doing with respect to your firm's quality control system — that is, reviewing the documentation of the firm's compliance with its system.

Practice Tip:

As this Manual has stated repeatedly, your firm does not need to have a formal written quality control document as long as you have completed an appropriate AICPA checklist summarizing the firm's policies and procedures. A well-planned and well-documented quality control system will, however, help cut the cost of your firm's review by enabling the peer review team to work more efficiently.

Engagements

13.511 A major part of your firm's peer review, particularly if you have 10 or fewer professionals, is the review of representative engagements to evaluate the firm's actual work product. Thus, review of your firm's engagement files will include review of working papers, reports issued, financial statements, and engagement correspondence. The review team will be looking for *documented* evidence that your firm has adhered to professional standards regarding:

1. Generally Accepted Accounting Principles (GAAP),
2. Statements on Standards for Accounting and Review Services (SSARS),
3. Generally Accepted Auditing Standards (GAAS),
4. Statements on Standards for Attestation Engagements (SSAE),
5. SQCS No. 1.

13.512 Except for SECPS peer reviews (where a "risk-based" engagement selection approach is used), the peer review team will cover at least 5% to 10% of your firm's accounting and auditing hours, but this range is usually exceeded in small and medium-size firms in order to get a reasonable cross section of the firm's practice.

Practice Tip:

Your firm's peer review team will use checklists that the AICPA has developed. Consider using these same checklists during your firm's internal inspection.

Practice Management Recommendations

13.513 One of the true benefits from your firm's peer review will be the many peripheral practice management comments and recommendations that your review team will normally make. These comments are often offered on an informal basis because they are not directly related to the review. Remember, however, that if you want to benefit from the review team's knowledge and insight, you must first be willing to share voluntarily certain business-related information. However, you are *not* required to disclose proprietary information about items like salaries, staff utilization percentages, write-off statistics, and practice development plans.

Summary of Results; Matters for Further Consideration Forms

13.514 As a result of any negative answers to questionnaires and other observations that your firm's peer review team makes, the review team captain will summarize items to be considered further. Some "no" answers on checklists will be dismissed either as insignificant or as isolated occurrences for which further investigation is not justified. The team captain may discuss other items with you as he or she evaluates whether they are significant. Based on this discussion, the team captain might decide that some points are immaterial or really not applicable to the situation.

13.515 Eventually, your firm's peer review team captain will enter some of the observations on Matters for Further Consideration (MFC) forms. As your firm's peer review draws to a close, you will be given all MFC forms. At that time you will be asked to indicate whether you agree or disagree with the observations and to add your own comments. If you have a valid objection to any finding, this is your opportunity to raise it and resolve the matter with the team captain. The team captain will add his or her final comments to the MFC form, which should then be signed by the engagement partner, the review team member who looked at the engagement, and the review team captain.

13.516 Not all comments on MFC forms affect the final outcome of a peer review. The team captain may still decide that, in the overall scheme of things, some or all MFC points might be either insignificant or isolated. The team captain will be looking for *patterns* and *pervasive* problems, not isolated errors.

Practice Tip:

Do not argue over insignificant points. You will have real issues to address in a short period of time. If you are argumentative over insignificant points, you will waste everyone's time and may even affect the review team's attitude toward the quality of your firm's practice. Any experienced reviewer will know — without your input — to disregard immaterial and irrelevant findings (unless they are collectively part of an overall pattern).

Exit Conference

13.517 At the conclusion of the field work or on-site phase of your firm's peer review, the review team will hold an exit conference to discuss the results of the review. The major matters described at your firm's exit conference should not come as a surprise to you because the review team captain should have kept you apprised of the status of the review as it progressed. Accordingly, you should not be confronted at the exit conference with any significant items that you have not already addressed as part of the previously described MFC process.

Practice Tip:

Many helpful suggestions will be made at the exit conference which may have no direct bearing on the outcome of your firm's peer review. They will not be included in the letter of comments that will be issued. Therefore, be sure to take good notes during the exit conference.

Firm Attendees

13.518 At a minimum, your firm's managing partner or equivalent, the head of the accounting and auditing practice, and the person responsible for monitoring the firm's quality control system should attend the exit conference (in a smaller firm, one person may perform all three of these functions). Many firms invite all partners and managers to their exit conferences. Some firms also invite other professional staff members, particularly those who perform accounting and auditing engagements, because having these personnel attend emphasizes the importance of the review results and allows them to hear all of the review team's comments directly from the source. Some firms request their review team captain to conduct a staff training session subsequent to the exit conference.

Typical Exit Conference Agenda

13.519 Typical exit conference agendas include:

- Proposed report letter;
- Proposed letter of comments;
- MFC forms and their resolutions;

- Minor points that did not warrant preparation of MFC forms but which the review team wants to bring to your attention;
- Efficiency and practice management suggestions (as noted in section 13.513, these suggestions are optional, but you should *ask* the review team captain to discuss them with you); *and*
- Administrative matters regarding conclusion of the peer review.

Proposed Peer Review Report and Letter of Comments

13.520 From an efficiency and elapsed-time standpoint, it is highly preferable for your firm's peer review team to draft its peer review report and letter of comments before the team captain leaves your firm's premises. However, the team captain actually has 30 days to provide you with the report and letters. If the final draft will not be ready in the field, be sure that the exit conference covers at least an outline, and preferably a complete pencil draft, of the specific items that will be included in the letter of comments and the peer review report. You do not want to be surprised at a later date.

Practice Tip:

If your firm's peer review team captain is able to draft your firm's peer review report and letter of comments in the field, you can contribute to the effort by providing typing or word-processing facilities and a typist. During the planning stages of your firm's peer review, you may want to inform the review team captain that, as a matter of efficiency, you would prefer to have the letters drafted in the field, if time permits.

Your Firm's Peer Review: Report and Acceptance

13.521 The final phase of your firm's peer review, which as noted above may actually begin on-site at the exit conference, is the report and acceptance phase. Issuance of, and response to, various written reports is followed by an established approval process.

Written Peer Review Reports

13.522 Your firm's peer review will result in the issuance of a peer review report and, in most cases, a letter of comments. If a letter of comments is issued, you will be expected to write a letter of response.

13.523 The peer review report (and letter of comments, if applicable) will be placed in the public record if your firm is a member of the PCPS or the SECPS. Otherwise, only the peer review committee of your firm's administering entity, and those members of its administrative staff who need to know, will ever see your firm's results. Peer review results will *not* be communicated to your state board of public accountancy or to anyone else, except for PCPS and PRP firms possibly to the AICPA's Peer Review Board and its staff.

13.524 Peer Review Report. The report on your firm's peer review is very similar to the auditor's report that you issue upon completion of an audit. It states the scope of the review, describes the general characteristics of a system of quality control, and includes an opinion on whether (1) your firm's quality

control met the objectives of the AICPA's quality control standards and (2) your firm was complying with its system. A PCPS or SECPS peer review report also gives an opinion on your firm's compliance with the relevant section's membership requirements.

13.525 If your firm has a CART peer review, the team captain will issue a peer review report on the administering entity's letterhead. If your firm has a firm-on-firm or association peer review, the report will be on the letterhead of the CPA firm or association that conducted the review. There are three types of peer review reports:

1. Unqualified,
2. Qualified, and
3. Adverse.

13.526 Unqualified Report. The AICPA's experience shows that an overwhelming majority of firms receive an unqualified report, although most of them also receive a letter of comments. Only a small percentage receive a qualified report and few indeed receive an adverse report.

13.527 Qualified Report. In most cases, if your firm receives a qualified report, it will be because some design or compliance problems within its quality control system need your attention. It means that although the firm's work product may be generally acceptable, its quality control system may not catch certain problems or may not adequately preclude the possibility of major problems in the future.

13.528 For example, although your firm's work might be generally good, several required disclosures might be missing from many of the financial statements with which the firm is associated. Even if no single set of financial statements was deemed to be misleading or materially substandard, the *pattern* would indicate that there is an ongoing supervision deficiency — possibly a lack of disclosure checklists, or the need for better CPE, or the need for more partner-level pre-issuance review of the financial statements. Depending on the severity and significance of the situation, this type of deficiency *could* result in a qualified report on your firm's quality control system.

13.529 Adverse Report. An adverse report results if the reviewers conclude that a firm's quality control policies and procedures are inadequate or do not meet the AICPA's quality control standards. One can also result if quality control policies and procedures are adequate but the firm's level of compliance is too low to provide reasonable assurance of conforming with professional standards. Historically, only about 2% of peer review reports have been adverse.

Letter of Comments

13.530 Almost all firms receive a letter of comments as a result of their reviews. You should view a letter of comments as essentially the same as the management letter comments that you issue to your firm's audit clients. For example, you often render a clean opinion on a client's audit, but you usually provide a management letter as an expected (and sometimes required) part of your service. Similarly, the letter of comments your firm receives as a result of its peer review does not negate an accompanying unqualified peer review report. It merely communicates some important concepts in a positive and educational fashion.

Your Firm's Letter of Response

13.531 Within 30 days (15 days for SECPS members) after a letter of comments has been issued to your firm, you must send a letter of response to the peer review committee of your administering entity. Your firm's review team captain will remind you of this and will help you to determine to whom to send it. Your response should normally be a brief but convincing description of how and when the corrective action has or will be taken. The letter of response should be signed in the name of your firm.

Practice Tip:

Be sure to word your letter of response in a positive manner. When your firm's review is evaluated and the final decision regarding whether you "passed" is made, your willingness to remedy problem areas will be taken into account. Your responses should be:

1. Comprehensive,
2. Genuine, *and*
3. Feasible.

Do *not* use language like "we will *study* the areas described in the letter or comments" or "we will *consider* implementing the suggested corrective actions." Vague promises may not be perceived as commitments to action and may result in otherwise avoidable delays in the final approval and acceptance of your firm's peer review.

It is a good idea to send a draft copy of your letter of response to your firm's peer review team captain for comments before mailing the final version to your firm's administering entity. If your firm belongs to the SECPS, you *must* submit a draft of the response to the team captain for review and comment before you submit it to the SECPS Peer Review Committee.

13.532 Follow Through. Be sure to take corrective actions as soon as possible so that the same problems do not appear in your firm's *next* review. You will be *expected* to have corrected all such problems by that time.

Disagreements

13.533 Disagreements between a reviewed firm and its peer review team about whether a point is serious or appropriate, or about the nature of a peer review report, are extremely rare. If you should become involved in such a disagreement, however, you may turn to a higher authority. For PCPS and PRP firms, the peer review committee of your administering entity may, at your request, intervene and, if necessary, the AICPA's Peer Review Board can resolve the matter. Similarly, SECPS firms may ask the SECPS Peer Review Committee to address disputes involving an SECPS peer review.

The Approval Process

13.534 Your firm's peer review is not approved and finalized until the appropriate authority notifies you to that effect. Therefore, do not publicize the results of your firm's review until you receive written notice of its acceptance.

13.535 Several things must transpire before your firm's peer review is approved. Upon leaving the field, your firm's review team captain must be satisfied that all checklists and review workpapers have been completed and reviewed. If the peer review report or letter of comments are not actually issued in the field, the team captain must complete these documents and provide them to you within 30 days. You must then submit your letter of response as described above. A technical review process ensues, which differs according to the type of peer review team you selected.

Practice Tip:

To expedite your official notification that your firm's peer review has been approved and accepted:

1. Request your peer review team captain to write his or her peer review report and letter of comments in the field if time permits (this action alone can accelerate the process by up to 30 days), *and*
2. Write your own letter of response immediately, and promptly send it, along with copies of the peer review report and letter of comments, to your firm's administering entity (this action can accelerate the process by another 30 days). SECPS firms must first submit a draft of the response to the team captain.

13.536 Approval of CART Peer Reviews. Approval of a CART peer review is a two-step process. First, the technical staff of the administering entity will examine CART review workpapers in detail, along with the review report, letter of comments, and your letter of response. It will evaluate your firm's peer review to be sure that it covered your practice adequately and that the conclusions reached and the letters issued are appropriate, based on the findings documented in the peer review workpapers. The person performing the technical evaluation will often want a number of questions resolved. Your firm's peer review team captain will usually resolve these questions with the staff by telephone. In rare instances, you may be asked to answer questions by telephone as well. In an unusual case, someone might have to revisit the field briefly.

13.537 Once it has completed its technical evaluation, the technical staff will send your firm's peer review to the appropriate peer review committee for final approval. In most cases, the committee will approve the review after discussion. However, it will not grant approval if there are questions about the scope or conduct of the review or the appropriateness of the peer review report, the letter of comments, or your letter of response. In such a case, your firm's administering entity will contact you about the steps that must be taken before the peer review can be accepted.

13.538 Sometimes there is a backlog of reviews awaiting technical evaluation. Further delays may occur while questions are being resolved. In addition, most peer review committees consist solely of volunteers

who meet only monthly or bimonthly. As a result, it may be several months between your firm's exit conference and the day you receive notification of final acceptance.

13.539 Approval of Firm-on-Firm and Association Peer Reviews. Like a CART peer review, approval of a firm-on-firm or association peer review also involves two steps — a technical evaluation and a review. However, firm-on-firm and association review workpapers are the responsibility of the reviewer. Accordingly, unless an SECPS peer review is involved, the technical staff of the administering entity *generally does not* review all of the peer review workpapers in detail. The technical staff *does*, however, review the peer review report, letter of comments, and your letter of response as well as certain summary information pertaining to the peer review. The staff evaluation will ensure that your practice was adequately covered and that the conclusions reached and the peer review report and letter of comments issued are appropriate, based on the summarized information presented. If the person performing the technical evaluation has questions to resolve, he or she will usually resolve them with your firm's peer review team captain by telephone. In rare instances, you may be asked to answer questions by telephone as well. As with CART reviews, in an unusual case, someone might have to revisit the field briefly.

13.540 Once the technical evaluation has been completed, your firm's peer review will be sent to the appropriate peer review committee for final approval — just as a CART review is. In most cases, the committee will approve the review after discussion. Approval will not be granted if there are questions about the scope or conduct of the review or the appropriateness of the peer review report, the letter of comments, or your letter of response. In such a case, your administering entity will contact you about the steps that must be taken before your peer review can be accepted.

13.541 Sometimes there is a backlog of reviews awaiting technical evaluation. Further delays may occur while questions are being resolved. In addition, in most cases peer review committees meet only monthly or bimonthly. As a result, it may be several months between your firm's exit conference and the day you receive notification of final acceptance.

Practice Tip:

The biggest difference in the approval process is that CART and all SECPS peer reviews (including firm-on firm) generally result in a detailed technical review of the peer review workpapers, while PCPS and PRP firm-on-firm and association reviews generally do not.

Failure to "Pass"; Possible Remedial Action

13.542 "Passing" is a subjective term, and it is not officially used in the peer review process. Certainly, if your firm receives an unqualified report you will know that it "passed," even if it receives a letter of comments (as most firms do).

13.543 The peer review programs are intended to be educational and remedial in nature, not punitive. As a result, remedial actions are designed to help you, not to cause you problems. Typical remedial actions are:

1. Review of your correction of problem areas during your firm's next regularly scheduled review;
2. Additional CPE;
3. Submission of annual inspection reports;
4. Engagement of a consultant, possibly to perform pre-issuance reviews or to assist you in the inspection process;
5. Revisit by review team captain; *or*
6. Accelerated review.

13.544 Any more serious action against your firm is unlikely unless you refuse to cooperate or fail to correct serious and pervasive deficiencies.

13.545 Review of Problem Areas During Your Firm's Next Regularly Scheduled Peer Review. Before your firm's peer review is accepted, your firm, in its letter of response, indicates the corrective actions that it will take concerning the matters in the letter of comments. In addition, the approving peer review committee agrees that the actions are appropriate and accepts the sincerity of your representations that your firm will take the corrective actions. Your firm's *next* peer review team (in three years) will be expected to assess the changes you have made. *For most firms, this is the only remedial action required.*

13.546 Additional CPE. Specific personnel in your firm may be required to take CPE courses in areas in which your firm appears to be deficient, particularly if the deficiency resulted in improper or inadequate reporting. In such a case, your firm may be asked to supply evidence, by a specified date, that the appropriate CPE has been obtained.

13.547 Submission of Annual Inspection Reports. Depending on the nature and severity of the findings in the peer review report, the administering entity may require the firm to submit a copy of its next annual inspection report to the administering entity or to a designated party who will report back to the entity. In some instances, your firm's peer review may be accepted subject to your agreement to hire a qualified person acceptable to the peer review committee to actually conduct your firm's next annual inspection and to report the inspection results directly to the administering entity. Any time spent by such a qualified person in conducting or evaluating your firm's inspection will be at your firm's expense.

13.548 Engagement of a Consultant. If your firm's administering entity believes that the facts indicate your firm needs outside help, it may require engaging a qualified consultant to help modify or monitor the firm's quality control system or to perform pre-issuance reviews of accounting and auditing engagements. It may also require the consultant to periodically report to the peer review committee about the extent of such consultations.

13.549 Revisit by Review Team Captain. If your firm's administering entity believes that certain review findings warrant close follow-up, it may require that the peer review team captain (or another qualified person) "revisit" your firm and report on whether it has taken appropriate corrective action.

13.550 Accelerated Peer Review. In rare cases in which extremely significant problems are noted during a review, the administering entity may determine that another, accelerated review should be conducted before the normal three-year interval has elapsed. This situation normally occurs only in the case of an adverse report. Even if an accelerated review is not required by the administering entity, a firm that has received a qualified or adverse peer review report may voluntarily request such an accelerated peer review in order to supersede the qualified/adverse report with one that will hopefully be unqualified.

13.600 SUMMARY

13.601 Nobody likes incurring the time and expense involved in having a peer review, but the benefits should outweigh the cost and inconvenience if you properly plan your firm's review. *You can help ensure that your firm will "pass" its review by following the guidance in this Manual.* You can also reduce the cost of the review by being prepared and by following the advice in this chapter with regard to arranging and expediting the review.

13.602 As discussed in this chapter, you should:

- Design and implement a quality control system that is appropriate for *your* firm;
- Become a member of the PCPS or SECPS or enroll in the AICPA Peer Review Program;
- Choose the type of peer review team that is best for your firm;
- Arrange for, prepare for, and expedite your firm's peer review;
- Understand and actively participate in the peer review process; *and*
- Understand and deal with the report and evaluation process that results from your firm's peer review.

13.700 SAMPLE DOCUMENTATION

13.701 You can expedite your firm's on-site peer review, and minimize its cost, if you:

- Plan your firm's peer review according to a suitable timetable (section 13.702),
- Send your firm's peer review team properly prepared client information (section 13.703), *and*
- Make sure that the information your firm's peer reviewers will need is at hand during the review.

13.702 Suggested On-Site Peer Review Preparation Timetable (Modify to your own firm's needs)

Prepare for your firm's on-site peer review by completing the following steps at each preparation phase:

	<u>Initials</u>	<u>Date</u>	<u>Comments</u>
Six Months Before Your Firm's Peer Review			
1. Determine the 12-month review year to be used.	_____	_____	_____
2. Determine the approximate field dates of the peer review.	_____	_____	_____
3. Submit CART scheduling request or select a firm or association to conduct the review.	_____	_____	_____
4. Provide administering entity or team captain with information for estimating the fee.	_____	_____	_____
Four Months Before Your Firm's Peer Review			
5. Select person to serve as review team liaison.	_____	_____	_____
6. Read the manuals and checklists that the peer reviewers will be using.	_____	_____	_____
Three Months Before Your Firm's Peer Review			
7. Sign and return engagement letter.	_____	_____	_____
Two Months Before Your Firm's Peer Review			
8. Submit all requested information to review team captain, including completed Quality Control Policies and Procedures Questionnaire.	_____	_____	_____
One Month Before Your Firm's Peer Review			
9. Complete all travel arrangements.	_____	_____	_____
10. Arrange for adequate work space.	_____	_____	_____
11. Begin gathering all documents that will be needed.	_____	_____	_____
Two Weeks Before Your Firm's Peer Review			
12. Confirm all arrangements, including field dates of review.	_____	_____	_____
One Week Before Your Firm's Peer Review			
13. Conduct CPE session for all personnel regarding the review.	_____	_____	_____
14. Finish gathering all documents, including pre-selected engagement working papers.	_____	_____	_____

Reviewed by: _____ Date: _____

13.703 Sample Client Listing

An Illustration of a List of Accounting and Auditing Clients

<u>Client Code</u>	<u>Period Covered</u>	<u>Highest Level of Service Provided*</u>	<u>Initial Eng.</u>	<u>Industry**</u>	<u>Name of Partner</u>	<u>Approx. Total Hours</u>
10001	9/30/93	A3	N	125	White	500
10002	10/31/93	A3	Y	165	Smith	350
10003	6/30/93	A2	N	320	Jones	275
10004	12/31/93	A5	N	260	Smith	150
(Bank Director's Exam)						
20001	12/31/93	R	Y	165	Smith	100
20002	3/31/94	R	N	245	White	125
20003	4/30/94	R	N	270	Jones	45
30001	12/31/93	C1	N	165	Smith	50
30002	3/31/94	C2	N	270	Jones	40
30003	6/30/93	C2	N	270	Jones	60
30004	9/30/93	C3	Y	270	Jones	40
30005	12/31/93	C1	N	220	White	80
Total						<u>1815</u>

* Denote the highest level of service by using the codes set forth in section 13.704.

** Denote the type of industry by using the codes set forth in section 13.705.

13.704 Codes for Level of Service

- A1 Audit of SEC Registrant
- A2 Audit Performed Under *Government Auditing Standards* Issued by the U.S. General Accounting Office
- A3 Other Regular Audits of Historical Financial Information
- A4 Examination of Prospective Financial Information
- A5 Other Special Audits — Identify

- R Review of Historical Financial Statements

- C1 Compilation of Historical Financial Statements With Disclosures
- C2 Compilation of Historical Financial Statements Omitting Substantially All Disclosures
- C3 Compilation of Prospective Financial Information

13.705 Industry Codes

- | | |
|---|---|
| 105 Advertising | 235 Leasing Companies |
| 110 Agricultural, Livestock, Forestry,
& Fishing | 240 Life Insurance Companies |
| 115 Airlines | 245 Manufacturing |
| 120 Auto Dealerships | 250 Mortgage Banking |
| 125 Banking | 255 Motor Carriers |
| 130 Broadcasting and Entertainment | 260 Not-for-Profit Organizations
(including Voluntary Health and
Welfare Organizations) |
| 135 Brokers and Dealers in Securities | 265 Pension Plans (including ERISA
audits) |
| 140 Brokers and Dealers in Commodities | 268 Personal Financial Statements |
| 145 Casinos | 270 Professional Services (Doctors,
Lawyers, Architects, etc.) |
| 150 Colleges and Universities | 200 Property and Liability Insurance
Companies |
| 155 Common Interest Realty Associations | 275 Publishing |
| 160 Computer Software Development
and Sales | 280 Real Estate Brokerage |
| 165 Construction Contractors | 285 Real Estate Development |
| 170 Continuing Care Retirement
Communities | 290 Real Estate Management |
| 175 Credit Unions | 295 Real Estate Investment Trusts |
| 180 Extractive Industries — Oil and Gas | 300 Reinsurance Companies |
| 185 Extractive Industries — Mining | 305 Retail Trade |
| 190 Finance Companies | 310 Savings and Loan Associations |
| 195 Franchisors | 320 School Districts |
| 205 Government Contractors | 315 Small Loan Companies |
| 210 Health Maintenance Organizations | 325 State and Local Government |
| 215 Hospitals and Nursing Homes | 330 Telephone Companies |
| 220 Hotels and Restaurants | 335 Utilities |
| 222 HUD Audits | 340 Wholesale Distributors |
| 225 Insurance Agents and Brokers | 999 Other (Describe) |
| 230 Investment Companies and
Mutual Funds | |

13.706 Checklist of Items to Have Available During On-Site Peer Review

Assemble the following documents for your firm's on-site peer review team:

	<u>Initials</u>	<u>Date</u>	<u>Comments</u>
1. Working papers and financial statements for engagements selected, together with completed engagement profile forms.	_____	_____	_____
2. Firm's accounting and auditing manuals.	_____	_____	_____
3. Independence representations from:			
a) Firm personnel (if required by firm policy).	_____	_____	_____
b) Other CPA firms (if applicable).	_____	_____	_____
4. Documentation of consultations with outside parties or firm experts.	_____	_____	_____
5. Personnel manuals and personnel files for all professional personnel.	_____	_____	_____
6. CPE records for all professional personnel.	_____	_____	_____
7. Scheduling documentation.	_____	_____	_____
8. Documentation of client acceptance and continuance procedures.	_____	_____	_____
9. Inspection report(s) for the most recent three-year period (if available).	_____	_____	_____

Reviewed by: _____ Date: _____

13.800 EXHIBITS

13.801 In preparing for your firm's on-site peer review, you might want to consider:

- Cost statistics of on-site peer or quality reviews (section 13.802),
- Hourly rates for CART reviews (sections 13.804 and 13.805),
- A summary of the nature of review reports (section 13.806), *and*
- General guidelines on the number of reviewers to be selected (section 13.807).

Review Cost Statistics

13.802 Average Cost of On-Site Peer Reviews. As shown in the schedule below, review costs vary significantly because of the nature of the firm's accounting and auditing practice and the number of professionals in the firm. For example, a firm whose practice is 70% accounting and auditing and 30% tax, will probably pay more than a firm with the opposite mix. Moreover, a firm with audits in various specialized or sensitive industries such as banking, governmental, and construction will pay more than a firm with the same number of audits that are all in one industry or in non-sensitive areas such as retail.

Average Cost of Reviews Conducted in 1991 and Early 1992*
by Review Teams Appointed by the AICPA or State CPA Societies

<i>Size of Firm</i>	<i>Number of Firms</i>	<i>Average Number of Professionals</i>	<i>Average Number of Accounting and Auditing Hours</i>	<i>Hourly Fees</i>	<i>Average Cost Expenses</i>	<i>Admin. Fee</i>	<i>Total Cost</i>
Sole practitioner, No Professional Staff	266	1	784	\$1580	\$105	\$146	\$1831
2-5 Professionals	394	3	1729	\$2195	\$188	\$228	\$2611
6-10 Professionals	128	7	3933	\$3046	\$258	\$285	\$3589
11-19 Professionals	31	14	8320	\$4543	\$504	\$446	\$5493
Over 20 Professionals	7	24	17148	\$6978	\$415	\$500	\$7893

13.803 Hourly Rates for CART Reviews. The materials in this exhibit summarize the hourly rates for CART Peer Reviews, PCPS CART reviews, and SECPS CART reviews.

* Latest cost figures available as of April 1, 1995.

13.804 CART Peer Review. Each state CPA society that arranges CART peer reviews for PCPS and PRP firms sets its own rates. An *example* of such rates (subject to change on a state-by-state basis) is:

	<u>Sole Practitioners With No Staff</u>	<u>Up to 10 Professionals</u>	<u>Over 10 Professionals</u>
Hourly rate for team captain	\$75	\$85	\$95
Hourly rate per member for other team members:			
• Per partner	65	75	85
• Per nonpartner	55	65	75

13.805 SECPS CART Peer Reviews. The SECPS hourly rate consists of an hourly fee, set by averaging the average standard billing rates of CART reviewers. Hourly rates are revised periodically and are exclusive of out-of-pocket expenses, which are billed at actual cost. The hourly rate varies according to the status of the reviewer(s) and the number of professionals in the reviewed firm. The present hourly rates are:

	<u>Number of Professionals in Reviewed Firm</u>		
	<u>1-10</u>	<u>11-49</u>	<u>50 or more</u>
Hourly rate for team captain	\$85	\$100	\$120
Hourly rate per member for other team members:			
• Per partner	75	90	105
• Per manager	65	80	90

Nature of Review Reports Issued

13.806 The PCPS, SECPS, and AICPA Peer Review Division have summarized their programs' statistics into the following breakdown of report types:

	<u>PCPS</u>	<u>SECPS</u>	<u>Quality Reviews (now PRP Reviews)</u>
Unqualified, without letter of comments (LOC)	15%	14%	21%
Unqualified, with LOC	74%	75%	61%
Modified	10%	10%	16%
Adverse	1%	1%	2%

13.807 General Guidelines on the Number of Reviewers To Be Selected

The budget for an on-site peer review and the number of reviewers selected for service on an on-site review team will vary based on the number of accounting and auditing hours of the reviewed firm and the nature of a firm's practice. Based on the experience in the peer review programs, the following guidelines have been prepared. A state society may depart from these guidelines, if its evaluation of the information submitted about the firm justifies such departure.

<u>Estimated Number of Accounting and Auditing Hours of the Reviewed Firm</u>	<u>Estimated for the Review*</u>	<u>Number of Reviewers to be Selected</u>
1 - 1000	12 - 20	1
1001 - 2000	15 - 27	1
2001 - 4000	20 - 35	1
4001 - 6000	25 - 40	1
6001 - 8000	30 - 45	1
8001 - 10000	35 - 50	1
10001 - 12000	40 - 60	2
12001 - 14000	45 - 70	2
14001 - 16000	55 - 80	2
16001 - 18000	65 - 95	2
18001 - 20000	75 - 105	2
20001 - 30000	85 - 125	3
30001 - 40000	95 - 135	3
40001 - 50001	105 - 150	3
50001 - 60000	115 - 160	4

* This estimate includes the time spent by the review team (a) planning the review; (b) performing the field work on the review; and (c) finalizing the report, letter of comments, and working papers on the review.

CHAPTER 14

OFF-SITE PEER REVIEWS

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CHAPTER 14

OFF-SITE PEER REVIEWS

14.000 OVERVIEW

14.001 The off-site peer reviews explained in this chapter are available as an option *only* if your firm has an accounting practice but does *not* have an audit practice—that is, your firm does not perform *any* audits of historical financial statements or examinations of forecasts or projections but do perform compilations and reviews. The number of audits or examinations performed is of no consequence in determining whether your firm has an audit practice. If your firm does *any* audits or examinations—even one—it has an audit practice and must have an on-site peer review (see Chapter 13). Even if your firm performs only one audit for *free* (for example, as a charitable donation), it has an audit practice.

Practice Tip:

If your firm is a member of the SECPS, it must have an on-site SECPS peer review, even if no audits are involved.

14.002 An off-site peer review is intended to provide your firm's reviewer with a reasonable basis for expressing *limited assurance* that the compilation and review engagements reviewed do not materially depart from the requirements of professional standards. In contrast to an on-site review, no opinion is expressed. Prior to April 3, 1995, off-site peer reviews were called "off-site quality reviews" and "PCPS report reviews."

14.003 Your goal should be not only for your firm to "pass" its peer review, but also to learn something from it while minimizing the costs. To accomplish this you must:

- Design and implement your firm's quality control system;
- Decide on the "right" program in which to enroll;
- Arrange and prepare for your firm's off-site peer review; *and*
- Understand and deal productively and effectively with the peer review process.

Practice Tip:

Even if your firm presently qualifies for an off-site peer review, you may want to voluntarily request an on-site peer review. An on-site peer review, although more expensive, is likely to be a more meaningful and educational experience. However, if you anticipate that the firm will be accepting any audits, no matter how small, you *may* find it ultimately more cost-effective to start out with an on-site review.

Special Exemptions for Firms With No Accounting and Auditing Practice

14.004 If your firm does not issue *any* financial statements of any kind (including forecasts and projections), it does not have to have a peer review. If this exception applies to your firm, contact your firm's peer review administering entity.

Practice Tip:

If your firm is presently exempt but takes on future audit, review, or compilation work, it will be expected to have the appropriate peer review, generally within 18 months of the fiscal year-end of the first auditing and accounting client it accepts.

PCPS/SECPS Notice Requirements

14.005 The PCPS and SECPS require member firms to send an exemption representation letter six months before their peer reviews would otherwise be due. The letter must state that:

1. The firm has no accounting and auditing practice, *and*
2. It will notify the section if it accepts one.

14.006 Certain additional information regarding PCPS and SECPS membership requirements is also required:

1. Photocopies of all required continuing professional education (CPE) records for each professional for each of the three most recent educational years, including proof of attendance;
2. The name, position, and length of service of each of the firm's professionals (proprietors, partners, or shareholders), with an indication of whether they are (a) CPAs and (b) members of the American Institute of Certified Public Accountants (AICPA); *and*
3. A copy of the written statement of broad principles that influence the firm's quality control and operating policies and procedures (SECPS only).

Overall Cost Considerations

14.007 Because of the greatly reduced scope of off-site peer reviews, they are considerably less expensive than on-site reviews. The billing formula varies from state to state for Committee-Appointed Review Team (CART) reviews. In some states, CART off-site reviews are billed based upon the number of engagements selected for review (ordinarily, two to three reports will be reviewed. However, this number may vary depending on the number of owners in a firm with responsibility for issuing compilation or review reports on financial statements). In other states, CART off-site reviews may be billed at an hourly rate.

14.008 Some state societies have adopted a rate structure for CART off-site reviews such as:

- \$250 for the first compilation or review report reviewed *and*
- \$150 for each additional report reviewed.

Practice Tip:

Just as on-site reviews can be streamlined for cost savings, some savings—although less dramatic—can be realized in an off-site review. The key is to fill out all questionnaires and forms as completely, accurately, and legibly as possible. The faster the reviewer can process your firm's information, the less expensive the review will be. You should particularly strive to minimize or eliminate the need for telephone calls from the reviewer to clarify matters that could have been communicated in your written responses.

14.100 DESIGNING AND IMPLEMENTING YOUR FIRM'S QUALITY CONTROL SYSTEM

14.101 Even if your firm conducts no audits, it definitely needs a quality control system, although it does not have to be as formal as the system it would need if the firm were having a full on-site peer review. If your firm does not yet have its quality control system in place and you are simply reading ahead to learn about the peer review process, be sure to study Chapter 2 for an overview of what your firm's quality control system should include, as well as Chapters 3–11 for specific details, and Chapter 12 for a summary of suggested documentation requirements and other compliance considerations.

Practice Tip:

Remember that, even though your firm's off-site peer review will be an abbreviation of a full on-site peer review, your firm is still fully responsible for adequate compliance with each of the quality control elements of *Statement on Quality Control Standards No. 1* (SQCS No. 1) that are applicable to your practice.

Who Defines Quality?

14.102 One of the questions asked most frequently by practitioners who are facing a peer review is: "Who defines quality?"

14.103 There is no standard answer. As discussed in this Manual, quality is a rather elusive and subjective concept when it is applied to a professional situation involving experience and judgment (see Chapters 1 and 2). Accordingly, your firm's reviewer will evaluate the quality of the reports and financial statements issued by the firm in terms of general standards for the profession.

14.200 SELECTING THE "RIGHT" PROGRAM IN WHICH TO ENROLL

14.201 If your firm performs compilations or reviews but does not perform audits, and you and the members of your staff want to remain affiliated with the AICPA, your firm must (unless it is a member of the SECPS):

1. Enroll in the AICPA Peer Review Program (PRP), *or*
2. Join the Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms. (Reviews of PCPS firms are administered under the AICPA Peer Review Program.)

14.202 As previously noted, *if your firm belongs to the SECPS, it must have a full—that is, on-site—peer review*. If your firm does not perform any audits, it is unlikely to be considering membership in the SECPS. But if it is, be sure to read about SECPS on-site peer reviews in Chapter 13.

14.203 The differences between an off-site peer review of a PCPS firm and an off-site peer review of a PRP firm are summarized below and in the portions of this chapter that follow.

14.204 Presented below is a comparison in tabular form.

	<u>PRP Peer Review</u>	<u>PCPS Off-Site Peer Review</u>
Results are confidential	X	
Results are on public record		X
Membership requirements are reviewed		X

Administering Entity

14.205 Off-site peer reviews are conducted as part of the AICPA Peer Review Program. If you and your associates are members of the AICPA, your firm *must* enroll in the AICPA Peer Review Program unless it is a member of the PCPS or SECPS of the AICPA's Division for CPA Firms.

14.206 If your firm is planning to have an off-site peer review, your state CPA society will probably administer the review. If so, contact your society for scheduling and other information. If not, contact

the AICPA's Peer Review Division at (201) 938-3030 for further information about which state will be your firm's administering entity.

Additional PCPS Considerations

14.207 If your firm belongs to the PCPS, it will have essentially the same off-site peer review as PRP firms, plus the reviewer will also review the firm's compliance with PCPS membership requirements. As previously discussed, if your firm belongs to the SECPS, it must have an *on-site* SECPS peer review.

14.208 Note that a firm must join the SECPS, and must have an SECPS on-site peer review, if it has *any* SEC clients.

Scope of Review

14.209 Although there were several differences between former off-site reviews (off-site quality reviews and PCPS report reviews), effective April 3, 1995, all off-site peer reviews of PCPS and PRP firms are now the same, except for the review of compliance with PCPS membership requirements as discussed in sections 14.207 and 14.214.

Description of an Off-Site Peer Review

14.210 Your firm's off-site peer review will consist of a reading of selected financial statements (and your compilation or review report on each of them). The engagements selected will include at least one review or compilation involving a complete set of financial statements (including full disclosures) for each partner of your firm who is responsible for issuing financial statements. At least two such engagements must ordinarily be selected and, if your firm performs both review and compilation engagements, both levels of service will be included. If your firm performs compilations on financial statements that omit substantially all disclosures, at least one of those compilations will also be selected (at least two if this is the only level of service your firm provides).

14.211 In contrast to an on-site peer review, your firm's engagement working papers will not be reviewed and staff personnel will not be interviewed. Based on certain information and representations that you will provide, your firm's reviewer will specify the number of engagements needed for each level of service and the industries from which to select them. Based on those guidelines, the reviewer will ask you to select and submit:

1. Copies of certain financial statements and your firm's related accountant's report, *and*
2. Engagement questionnaires.

14.212 Your firm's off-site peer review will not specifically cover the nine elements of quality control. It will focus specifically on your firm's work product and not on its underlying quality control system. Accordingly, the report and letter of comments issued will cover items noted during the review of your firm's reports, but will not render an opinion on your system.

14.213 Off-site peer reviews of PRP firms are confidential and the results will not be made public.

Off-Site Peer Reviews of PCPS Firms

14.214 If your firm belongs to the PCPS, and has an off-site peer review, the review will be the same as the off-site review of a PRP firm but will also include a review of evidential matter regarding the firm's compliance with PCPS membership requirements, including a review of CPE records for the past three years.

Is an Off-Site Peer Review Harder to Pass for PCPS Firms Than for PRP Firms?

14.215 The authors believe that because firms now have the same review, except for the review of a PCPS firm's compliance with PCPS membership requirements, if your firm wants to participate in the many professional benefits of PCPS membership, compliance with PCPS membership requirements should not be a major deterrent for you.

Type of Review Team

14.216 Three types of review teams can perform your firm's off-site peer review:

1. A Committee-Appointed Review Team (CART),
2. A firm-on-firm review team, if your state's administering entity elects to permit such teams, *or*
3. An authorized association of CPA firms.

14.217 Some state CPA societies may decide to permit only CART off-site reviews and specify whether the CART will consist of an appropriately selected independent practitioner or a qualified state society staff member. You are urged to check the current requirements in your own state.

14.300 PREPARING FOR YOUR FIRM'S OFF-SITE PEER REVIEW

14.301 Once you have decided in which program to enroll, you will have to take affirmative steps to prepare your firm for its review:

1. Schedule your firm's review,
2. Select a proper review year,
3. Assemble necessary information, *and*
4. Become familiar with the forms and checklists your firm's reviewer will be using.

Scheduling Your Firm's Off-Site Peer Review

14.302 If your firm performs no audits (or examinations of prospective financial statements) but does provide compilation or review services, the state CPA society administering your review will contact you to help you schedule the firm's off-site peer review. It will notify you of the information required for the review and tell you the due dates that you must observe.

14.303 To arrange for your firm's off-site peer review, you must submit a scheduling form to the state CPA society that administers peer reviews for your state. If your state CPA society administers the program, contact it for further information. Otherwise, contact the AICPA's Peer Review Division at (201) 938-3030.

**Selection of Proper "Review Year"
(Period Peer Review Will Cover)**

14.304 The AICPA does not specify the selection of your firm's review year. Because a large number of firms qualify for off-site reviews, these reviews are conducted all year (except during the tax season). Your firm's review year is not necessarily the firm's fiscal year; rather, it is a current 12-month period that you and your firm's reviewer will mutually select. That period should end within six months of the performance of your firm's peer review.

Determination of Engagements Falling Within Review Year

14.305 Engagements selected for review are defined quite differently in the off-site peer review program than in the on-site program. For off-site peer reviews, the determination is made on the basis of when your firm actually issued the financial statements and *not* according to the firm's clients' accounting periods.

Practice Tip:

Your firm's peer review year generally should not end earlier than December 31 of the year preceding your review.

Background Information to Assemble

14.306 You will need to prepare information about your firm's engagements for use by the reviewer. This can be easily and efficiently accomplished by completing an "Off-Site Peer Review Engagement Summary Form," which you can obtain from your firm's off-site peer reviewer. An example of the form appears at section 14.703. The reviewer will study this form during the planning phase of the review. The form summarizes your firm's practice by major industry categories and includes:

- Nature of the highest level of service provided (review, compilations, compilations without disclosures, and so forth), *and*
- Number of engagements of each type performed by each partner, shareholder, or proprietor of your firm.

14.307 Your firm's peer reviewer will notify you of the number and types of engagements that will be reviewed. At the same time, the reviewer will ask you to select appropriate engagements and to submit a copy of the financial statements and the accountant's report for each of them, along with a completed engagement questionnaire.

Practice Tip:

You can greatly help your firm's reviewer conduct an efficient review by carefully completing the engagement questionnaires and other forms the reviewer will provide you. By doing so on a timely basis, you will reduce or eliminate unnecessary and often time-consuming telephone calls and written queries from the reviewer and will expedite completion of the peer review.

14.308 PCPS Firms. The information required of PCPS member firms is slightly more extensive than that required for other off-site peer reviews. PCPS member firms must also provide copies of CPE documentation for all professionals and other items pertaining to PCPS membership requirements.

14.309 PCPS CPE Documentation. If your firm belongs to the PCPS, it will need to submit photocopies of CPE records for each professional for each educational year since the firm joined the PCPS (not exceeding three years).

14.310 Other PCPS Information. PCPS member firms must also provide the reviewer with:

1. Evidence of payment of AICPA membership dues for all partners in the firm eligible for membership,
2. Evidence of payment of the firm's annual dues to the PCPS, *and*
3. A copy of the firm's most recent annual report that was filed with the PCPS.

Review of Reviewers' Forms and Checklists

14.311 The authors recommend that one of the best ways to be prepared for your firm's peer review and to minimize the reviewer's questions is to be familiar with the forms and checklists that the reviewer will fill out during the review. You may already be somewhat familiar with these materials from your participation in the internal inspection process but, shortly before your firm's review, take the time to refresh your understanding. You can purchase the *AICPA Peer Review Program Manual* from the AICPA for \$150 in looseleaf or \$75 in paperback.

14.400 YOUR FIRM'S OFF-SITE PEER REVIEW: THE INITIAL PROCESS

14.401 Certainly, your firm's off-site peer review should be less traumatic than one that is conducted on-site. For one thing, it is significantly less in scope. In addition, if your firm has complied with professional standards and if you have filled out all of the forms and questionnaires properly and completely, you will minimize administrative contact with your reviewer. This will not only save you time and trouble but will also minimize the cost of your firm's review.

What Your Off-Site Peer Reviewer Will Examine

14.402 Your firm's off-site peer reviewer will not be on a witch-hunt. Instead, the reviewer will evaluate whether the reports and financial statements issued by the firm appear to conform with professional standards. Generally accepted accounting principles (GAAP) and the reporting standards of

the Statements on Standards for Accounting and Review Services (SSARS) will be emphasized, while the performance standards of the SSARS will not be closely evaluated. In fact, because of the limited work the reviewer will perform, he or she will express no assurance on your firm's quality control policies and procedures.

14.403 Additionally, as noted above, if your firm belongs to the PCPS, the peer reviewer will scrutinize CPE records and certain other documents for compliance with PCPS membership requirements.

Summary of Results

14.404 Based upon a reading of the information that you will supply, and a reading of the financial statements and accountants' reports submitted for review, your firm's peer reviewer will complete certain AICPA checklists. These checklists will in turn become the basis for the conclusions drawn about your review. The engagement checklists are designed so that the "right" answer is "yes" (or "n/a"). As a result of checklist items answered "no," the reviewer will summarize items to be considered further. Some "no" answers on the checklists may be quickly dismissed as insignificant, but the reviewer may discuss other items with you by telephone as he or she evaluates whether they are significant.

14.405 Your firm's reviewer may enter some observations on Matters for Further Consideration (MFC) forms. These will either be discussed with you by telephone, or your reviewer may decide to mail or fax them to you for your written response. If you have a valid objection to any MFC finding, raise it immediately at this point and resolve the matter with the reviewer. Not all comments on MFC forms affect the final outcome of a peer review. Your firm's reviewer might ultimately decide that, in the overall scheme of things, certain MFC points are insignificant.

Exit Conference

14.406 At the conclusion of your firm's off-site peer review, the reviewer will call you and hold a telephone exit conference to discuss the results of the review. In practice, this often occurs during the same telephone conversation in which you discuss the MFCs.

14.500 YOUR FIRM'S OFF-SITE PEER REVIEW: REPORT AND ACCEPTANCE

14.501 As with on-site peer reviews, the final phase of an off-site peer review is the report and acceptance phase. Issuance of, and response to, various written reports is followed by an approval process.

Written Peer Review Reports

14.502 Your off-site peer review will result in the issuance of a peer review report. If a letter of comments is also issued, you will be expected to write a letter of response, as described below.

Peer Review Report

14.503 There are three types of reports:



1. Unqualified,
2. Qualified, *or*
3. Adverse.

14.504 Your firm's peer reviewer will not have seen enough of the firm's actual work to be able to express an opinion on its quality control policies and procedures. Instead, the peer review report will state whether anything came to the reviewer's attention that caused him or her to believe that the firm's compilation and review reports did not conform with professional standards. If material departures from such standards are noted, they will be described in the report.

14.505 Qualified Report. If your firm receives a qualified report, it will be because there were some items noted during the review that the reviewer deemed to be significant departures from professional standards. Examples of such significant departures include:

- Accountant's report used GAAP wording, but financial statements were prepared on an other comprehensive basis of accounting.
- Compiled financial statements omitted substantially all disclosures, but the third paragraph of compilation report did not mention that fact.
- Reviewed financial statements omitted notes or the notes omitted information material to the understanding of the financial statements.
- Accountant's report was not issued with the financial statements.
- GAAP financial statements omitted a statement of cash flows and the accountant's report did not mention the omission; or the statement of cash flows was not presented for every period that a statement of income was presented and the accountant's report did not mention the omission.
- Statement of changes in financial position was presented instead of a statement of cash flows where one was required, or the statement of cash flows did not conform with SFAS No. 95.
- Reports were not updated to current SSARS language.
- Financial statements contained material departures from GAAP and the accountant's report was not appropriately modified.
- Firm was not independent and a review report was issued, or a compilation report was issued that did not note the lack of independence.

14.506 Findings that are considered isolated with respect to on-site peer reviews and that may not result in a qualified on-site report (because they may not be indicative of an overall pervasive defect in the firm's quality control *system*) will often, however, give rise to a qualified off-site peer review report. This is because the off-site reviews report only on whether the financial statements reviewed contain departures from professional standards but do not extend to an evaluation of the firm's quality control system taken as a whole. Thus, significant departures such as those listed above will often result in a qualified off-site report, even if the occurrence was an isolated one.

14.507 Adverse Report. A report is always issued for an off-site peer review, even if it is adverse. An adverse report results if a peer reviewer concludes that the reports and financial statements issued by your firm do not comply with professional standards. Generally, if two or more engagements submitted for an off-site peer review are deemed to be "substandard," the peer review report will automatically be adverse. Although an off-site review does not provide a basis for expressing any form of assurance on a firm's quality control policies and procedures, in the case of an adverse report, the reviewer will have a basis for concluding in the report that the firm's quality control policies and procedures were deficient.

Letter of Comments

14.508 Most firms receive a letter of comments in addition to the peer review report itself. You should view a letter of comments as essentially the equivalent of the management comments that CPAs issue to audit clients. A CPA often renders a clean opinion on a client's audit but still provides a management letter as an expected (and sometimes required) part of the engagement. Similarly, a letter of comments does not negate an unqualified peer review report. It merely communicates some important concepts in a positive and educational fashion.

Your Letter of Response

14.509 Within 30 days after a letter of comments has been issued to your firm, send your firm's letter of response to the peer review committee of your firm's administering entity. Your response should normally be a brief but convincing description of how and when the corrective action has or will be taken.

Practice Tip:

Be sure to word your letter of response in a positive manner. When your firm's review is evaluated and the final decision about whether you "passed" is made, your willingness to remedy problem areas will be taken into account. Your response should be:

1. Comprehensive,
2. Genuine, *and*
3. Feasible.

Do *not* use language like "we will *study* the areas described in the letter of comments" or "we will *consider* implementing the suggested corrective actions." Vague promises may not be perceived as commitments to action and may result in delays in the final approval of your firm's peer review.

Your firm's peer reviewer can help you draft your response if you feel that you need assistance.

Disagreements

14.510 Disagreements between the reviewed firm and the reviewer about whether a point is serious or

appropriate, or about the nature of a report are extremely rare. If you should become involved in such a disagreement, however, you may turn to a higher authority. The peer review committee of your firm's administering entity may, at your request, intervene; if necessary, the AICPA's Peer Review Board can resolve the matter.

The Approval Process

14.511 Your firm's off-site peer review is not approved and finalized until the state CPA society notifies you to that effect. Therefore, do not publicize the results of the peer review until you receive such notice.

14.512 Several things must transpire before your firm's review is approved. The process is basically the same for on-site peer reviews.

14.513 First, your firm's reviewer must be satisfied that all checklists and peer review workpapers have been completed. Then the technical staff of the administering entity will examine the review workpapers in detail, along with the peer review report, letter of comments, and your letter of response. It will evaluate the peer review to be sure that it has covered your firm's practice adequately and that the conclusions reached and the letters issued are appropriate, based on the findings documented in the peer review workpapers. The person performing the technical evaluation may have questions to resolve after reading the peer review workpapers. He or she will usually resolve these questions with your firm's reviewer. In rare instances, you may be asked to answer questions as well.

14.514 Once it has completed its technical evaluation, the technical staff will send your firm's peer review to the state CPA society's peer review committee for final approval. In most cases, the committee will approve the review after discussion. However, it will not grant approval if there are questions about the scope or conduct of the review or the appropriateness of the report, the letter of comments, or your letter of response. In such a case, your firm's administering entity will contact you about the steps that must be taken before your firm's review can be accepted.

14.515 Sometimes there is a backlog of reviews awaiting technical evaluation. Further delays may occur while questions are being resolved. In addition, most peer review committees meet only monthly or bimonthly. As a result, it may be *several months* between your firm's exit conference and the day you receive notification of acceptance.

Failure to "Pass"; Possible Remedial Action

14.516 "Passing" is a subjective term, and it is not officially used in the peer review process. Certainly, if your firm receives an unqualified peer review report you will know that it "passed," even if it receives a letter of comments (as most firms do).

14.517 The Peer Review Program is intended to be educational and remedial in nature, not punitive. As a result, remedial actions are designed to help you, not to cause you problems. Typical remedial actions are:

1. Additional CPE *and*
2. An accelerated off-site review.

14.518 Additional CPE. Specific personnel in your firm may be required to take CPE courses in areas in which your firm appears to be deficient, particularly if the deficiency resulted in quality control weaknesses or improper or inadequate reporting. In such a case, you may be asked to supply evidence by a specified date that the appropriate CPE has been obtained.

14.519 Accelerated Off-Site Peer Review. In rare cases in which extremely significant problems are noted during a review, the administering entity may determine that another, accelerated review should be conducted before the normal three-year interval has elapsed. This situation normally occurs only in the case of an adverse report.

14.600 SUMMARY

14.601 If your firm issues compilation or review reports but performs no audits of historical financial statements or examinations of forecasts or projections, it may elect to have an off-site peer review in lieu of a more comprehensive (and more expensive) full-scope on-site review.

14.602 *You can help ensure that your firm will "pass" its review by following the guidance in this Manual.* As discussed in this chapter, you should:

- Design and implement your firm's quality control system,
- Decide on the "right" program in which to enroll,
- Arrange and prepare for your firm's off-site peer review, *and*
- Understand and deal productively and effectively with the peer review process.

14.700 SAMPLE DOCUMENTATION

14.701 An *Off-Site Peer Review Engagement Summary Form* is presented in section 14.703. This form is reprinted from the AICPA *Peer Review Program Manual*, section 7100.07.

14.702 A *Checklist for PCPS Firms Having an Off-Site Peer Review* is presented in section 14.708 to assist PCPS member firms in preparing for their off-site peer reviews.



14.703 OFF-SITE PEER REVIEW ENGAGEMENT SUMMARY FORM

Industry of the Client*	Level of Service Provided**	Number of Engagements Performed		
		Owner 1	Owner 2	Owner 3
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			
	A			
	R			
	C			
	CO			
	CP			

Signature: _____ Date: _____

Title: _____

* Please use the industry codes in section 14.705.
** Please use the service codes in section 14.704.

14.704 Codes for Level of Service

- A Agreed-upon procedure engagement
- R Review of historical or personal financial statements
- C Compilation of historical or personal financial statements with disclosures
- CO Compilation of historical or personal financial statements that omits substantially all disclosures
- CP Compilation of prospective financial information

14.705 Industry Codes

- | | |
|---|---|
| 105 Advertising | 235 Leasing Companies |
| 110 Agricultural, Livestock, Forestry,
& Fishing | 240 Life Insurance Companies |
| 115 Airlines | 245 Manufacturing |
| 120 Auto Dealerships | 250 Mortgage Banking |
| 125 Banking | 255 Motor Carriers |
| 130 Broadcasting and Entertainment | 260 Not-for-Profit Organizations
(including Voluntary Health and
Welfare Organizations) |
| 135 Brokers and Dealers in Securities | 265 Pension Plans (including
ERISA audits) |
| 140 Brokers and Dealers in Commodities | 268 Personal Financial Statements |
| 145 Casinos | 270 Professional Services (Doctors,
Lawyers, Architects, etc.) |
| 150 Colleges and Universities | 200 Property and Liability Insurance
Companies |
| 155 Common Interest Realty Associations | 275 Publishing |
| 160 Computer Software Development
and Sales | 280 Real Estate Brokerage |
| 165 Construction Contractors | 285 Real Estate Development |
| 170 Continuing Care Retirement
Communities | 290 Real Estate Management |
| 175 Credit Unions | 295 Real Estate Investment Trusts |
| 180 Extractive Industries—Oil and Gas | 300 Reinsurance Companies |
| 185 Extractive Industries—Mining | 305 Retail Trade |
| 190 Finance Companies | 310 Savings and Loan Associations |
| 195 Franchisors | 320 School Districts |
| 205 Government Contractors | 315 Small Loan Companies |
| 210 Health Maintenance Organizations | 325 State and Local Government |
| 215 Hospitals and Nursing Homes | 330 Telephone Companies |
| 220 Hotels and Restaurants | 335 Utilities |
| 222 HUD Audits | 340 Wholesale Distributors |
| 225 Insurance Agents and Brokers | 999 Other (Describe) |
| 230 Investment Companies and
Mutual Funds | |

Checklist for Firms Having an Off-Site Peer Review

14.706 The purpose of the checklist in section 14.708 is to assist PCPS member firms to comply with the membership requirements of the Private Companies Practice Section.

14.707 Questions regarding these instructions or any other materials, or about the peer review programs in general should be directed to the administering entity for your state or to the AICPA Peer Review Division at (201) 938-3030.

14.708 Checklist for PCPS Firms Having an Off-Site Peer Review**PRIOR TO THE REVIEW****Initial****Date**

- | | | |
|--|-------|-------|
| 1. Advise the administering entity of the firm's intention to undergo an off-site peer review and your preference for the type of review (CART, firm-on-firm, or association sponsored). (This should be done by responding on a timely basis to a request the firm will receive from the staff for information on the scheduling of a required review.) | _____ | _____ |
| 2. The administering entity or reviewer will prepare an engagement letter setting forth the terms and conditions of the report review. Sign and return a copy of the engagement letter to the appropriate party. | _____ | _____ |
| 3. Submit to the reviewer upon request and on a timely basis: | | |
| a. A list of the firm's entire professional staff showing name, position, length of service, and whether the individual is a CPA and a member of the AICPA. | _____ | _____ |
| b. Summary of CPE participation of all professionals in the firm for the three most recent educational years of the firm or since its membership in the section, whichever is less. | _____ | _____ |
| c. Evidence of payment of AICPA membership dues for all the partners in the firm eligible for membership and its dues to the AICPA Division for CPA Firms (the section). | _____ | _____ |
| d. A copy of the firm's most recent annual report that was filed with the PCPS. | _____ | _____ |
| e. The report, letter of comments and letter of response issued in connection with the firm's previous practice-monitoring review, if any. | _____ | _____ |
| 4. Within 30 days of being notified by the reviewer of the types of engagements selected for review, for each engagement selected, forward the following to the reviewer: | | |
| a. A copy of the financial statements and accountant's report. (The client's name may be deleted.) | _____ | _____ |



Initial Date

- b. A completed "Engagement Questionnaire."

DURING THE REVIEW

5. Respond to the reviewer's inquiries and requests for further information.

AFTER THE REVIEW

6. Upon receipt of the report and letter of comments, if any, prepare a response to the matters requiring action in the letter of comments. The response should describe the actions taken or planned with respect to such matters.

7. Within 30 days of the date the report and letter of comments, if any, are issued, submit to the administering entity a copy of the report, and if applicable, the letter of comments and the firm's response thereto. The reviewed firm should not publicize the results of the review or distribute copies of the report to its personnel, its clients or others until it has been advised that the report has been accepted by the appropriate peer review committee.

CHAPTER 15
POSITIVE ENFORCEMENT

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CHAPTER 15

POSITIVE ENFORCEMENT

15.000 OVERVIEW

15.001 Most states have enacted some sort of positive enforcement program or are likely to do so in the near future. These programs are generally mandatory and often include statutory enforcement provisions. Unlike the American Institute of Certified Public Accountants (AICPA) programs, a positive enforcement program applies to all licensees within a particular state. In fact, positive enforcement is likely to represent the cutting edge of quality control for CPA firms in the future.

15.002 This chapter explains what you should know, and do, to comply with your state's positive enforcement program, particularly:

- How positive enforcement programs are related to AICPA peer review programs, *and*
- How positive enforcement programs work.

What "Positive Enforcement" Means

15.003 The National Association of State Boards of Accountancy (NASBA) defines "positive enforcement" as "the process of monitoring the work products of practice units in order to monitor the quality of financial reporting." NASBA considers a state board of accountancy to have a positive enforcement program if it either (1) reviews publicly available financial statements and reports thereon or (2) requires practice units to submit financial statements and reports thereon to it for review.

15.004 Some states have enacted practice monitoring or "quality review" requirements that do not necessarily meet the NASBA definition of "positive enforcement." In this Manual, however, the authors consider all such programs to be "positive enforcement" programs for discussion purposes.

15.100 RELATIONSHIP BETWEEN "POSITIVE ENFORCEMENT" AND AICPA PRACTICE MONITORING STANDARDS

15.101 Participation in a state accountancy board positive enforcement program does not satisfy the AICPA's practice monitoring requirements. The only way you can satisfy the AICPA's requirements is for your firm to have an AICPA-approved peer review.

15.102 Fortunately, the opposite is probably not true. Your state's positive enforcement program will probably accept participation in one of the AICPA-approved programs. So, your firm probably will not have to have two separate reviews because its AICPA-approved peer review should suffice for all purposes. Most state boards of accountancy are operating under severe staffing and budgetary constraints. Accordingly, they have welcomed the AICPA's efforts and usually accept peer reviews by an organization (like the AICPA) that meets certain standards.

15.103 A more detailed breakdown of how your firm's AICPA-approved review will relate to your state's positive enforcement program is provided in the discussion below of how positive enforcement operates.

Practice Tip:

For your own protection, periodically confirm the specific requirements of your own state board of accountancy. Additionally, although your state board of accountancy may accept reviews other than AICPA peer reviews, the authors recommend that your firm have an AICPA-approved review so that you and your partners and professional staff members can retain your individual AICPA memberships.

15.200 OPERATION OF POSITIVE ENFORCEMENT PROGRAMS

15.201 As mentioned at the beginning of this chapter, most states have enacted some sort of positive enforcement program or are likely to do so in the near future. The requirements of the various state boards of accountancy, however, are in a state of flux. Because of the likelihood of significant changes over the next few years, it would be dangerously misleading to try to definitively list the requirements of the different states at this time. However, this chapter provides you with at least some insight into some evolving operational issues and rules.

Practice Tip:

You *must* stay abreast of the requirements in your own state. Only a few states are *not* moving forward with some type of positive enforcement plans. Even in those states, the situation is fluid; the reason cited for inaction is a lack of enabling legislation, and that situation can quickly change.

In addition, NASBA is presently working on a plan to help standardize the positive enforcement requirements in the various states. State boards must, among other things, identify the minimum standards that a practice monitoring program must meet and oversee the compliance of practice units in their jurisdictions with the applicable practice monitoring requirements.

Type of Review: On-Site or Off-Site

15.202 Because of time and budget constraints, some state positive enforcement programs may be limited, at least at first, to report review programs. Thus, if you practice in one of those states and if your firm does not perform any audits, your firm's positive enforcement requirement will probably be essentially the same as an off-site peer review. In such states if your firm does perform audits, its positive enforcement requirement will probably be less intensive than the peer review it will need to satisfy the AICPA's requirements. In other states, positive enforcement requirements will probably be very similar to the AICPA's practice monitoring requirements, or they may require your firm to have an actual peer review. Accordingly, you can rest assured that your firm's AICPA-approved peer review is likely to be acceptable to your state board of accountancy.

Scope of Positive Enforcement Program

15.203 Your state board's positive enforcement program probably will apply to all practice units—including sole proprietorships, partnerships, and professional corporations—that are licensed to practice in your state. Some small practitioners may drop out of the AICPA to avoid having a peer review, but they will still have to have some type of peer review if they wish to remain licensed to practice.

Enforcement; Impact of Noncompliance

15.204 Although the initial thrust in most states has been educational rather than disciplinary, enforceable constructive actions might be prescribed in some instances. If your firm "fails" its AICPA peer review, and flagrantly refuses to take corrective actions, the worst thing that can possibly happen is that you no longer will be allowed to be an AICPA member. But if your firm "fails" its positive enforcement review and stubbornly refuses to rectify the situation, its practice license will probably be suspended or terminated. Thus, the positive enforcement programs may become enforcement-oriented in some situations.

15.205 The authors believe that, although enforcement actions against CPA firms by state boards of accountancy will probably be relatively rare, they do occur and will continue to occur, just as individual certificates are sometimes suspended for failure to meet well-publicized state continuing professional education (CPE) requirements.

Confidentiality

15.206 In most states, the positive enforcement process is confidential unless it results in a formal board action finding work to be substandard. In such a case, the information may become available for public inspection.

Review and Oversight

15.207 Your state board's positive enforcement program may recognize various review programs other than the AICPA-approved programs. It probably will perform an oversight function regarding the various review programs that may become available.

15.300 SUMMARY: WHAT YOUR FIRM MUST DO TO COMPLY WITH POSITIVE ENFORCEMENT REQUIREMENTS

15.301 Your firm's participation in the AICPA's peer review program (including the PCPS or SECPS peer review program) will probably satisfy your state's positive enforcement requirements. Even though you may be able to satisfy state positive enforcement requirements through a different program, your firm's AICPA membership is a valuable credential, and the authors recommend that you remain in an AICPA-approved peer review program.

15.400 EXHIBITS

State Board "Quality Review" Programs

15.401 Although the AICPA has universally adopted the term "peer review" for its practice monitoring programs, many states continue to use the term "quality review." According to the latest information available, 26 states had some form of a "quality review" program in effect, 19 of which require "quality review" as a condition for relicensure. Some states and the District of Columbia are either considering or developing positive enforcement programs. In the remaining jurisdictions, where the authors are not aware of plans to move forward with positive enforcement, one of the principal reasons for inaction has been a lack of enabling legislation.

15.402 The situation regarding positive enforcement is in flux, and you *must* stay abreast of the requirements in your own state. Section 15.403 provides:

- a list of states that have adopted some form of a "quality review" program, and
- a list of states that require such a program as a condition for relicensure.

As discussed, this list is subject to revision. Therefore it is important that you periodically check with your own state board of accountancy regarding its current requirements.

Practice Tip:

The requirements and extent of positive enforcement programs vary widely from state to state. States that have positive enforcement programs on their books do not necessarily have statutory authority either to implement their own practice monitoring programs or to extend present reviews of publicly available reports to nonpublic reports. *Check with your own state board regarding the specific details applicable in your state.*

Exhibit 15-1

STATE BOARD PRACTICE MONITORING PROGRAMS

15.403

STATE	PROGRAM	REQUIRED FOR RELICENSURE
Alabama	Practice Review Program (Reg. Chp. 30-X-8)	X
Alaska	No Program. Statute provides for a "Quality Review" Program, as determined by Board (Sec. 8.04.426)	
Arizona	No Program	
Arkansas	"Quality Review" Program (Sec. 17-12-507; Reg. Sec. 14.1)	X ¹
California	Financial Statement Review (Reg. Sec. 89.1(a))	X ²
Colorado	No Program	
Connecticut	"Quality Review" program (Sec. 20-281; Reg. Sec. 20-281-1 through -12)	X
Delaware	No Program	
District of Columbia	No Program	
Florida	No Program. Board has power to implement program (Sec. 473.315(3))	
Georgia	Report Monitoring Program (Sec. 43-3-23.1; Reg. Sec. 20-9-.01(6))	X
Guam	No Program. Board has power to implement program (Sec. 54001)	
Hawaii	"Quality Review" of Publicly Available Work Program (Sec. 466-13)	
Idaho	No Program. The statutes provide for a "quality review" program, as determined by the Board (Sec. 54-214; approved 3/27/93, effective one year after legislative review and approval of Board regulations)	
Illinois	No Program. Legislation pending to establish a program (HB 1772)	
Indiana	No Program. Statute provides for a "Quality Review" Program, as determined by Board (Chp. 5, Sec. 8)	
Iowa	Peer Review Program (Sec. 542C.6; Reg. Chp. 17)	X

STATE	PROGRAM	REQUIRED FOR RELICENSURE
Kansas	Positive Enforcement Program (Art. 5, Sec. 1-501; Reg. Art. 11, rule 74-11-1 through -5)	
Kentucky	Quality Enhancement Program (201 KAR 1:068)	
Louisiana	Practice Monitoring Programs (Sec. 75(12); Reg. Chp. 25, Sec. 2504)	X
Maine	No Program	
Maryland	No Program	
Massachusetts	No Program. Board has power to implement program (Sec. 87A 1/2(5))	
Michigan	No Program	
Minnesota	No Program. Legislation pending to establish a program (HB 466, SB 1121)	
Mississippi	Practice Review Program (Rule V.F.)	
Missouri	No Program. Peer review required of licensees who have substandard reports on financial statements, as condition of registration (Sec. 326.055)	
Montana	Profession Monitoring Program (Sec. 37-50-203(2)(h); Reg. Subchp. 9)	X
Nebraska	Quality Enhancement Program (Reg. Chp. 4 006.07A)	X
Nevada	Program to review quality of financial reports (Rule 628.261 through .420)	X
New Hampshire	No Program. Legislation pending to establish a program (HB 1194)	
New Jersey	Quality Enhancement Program (Reg. Subchp. 5)	X ³
New Mexico	No Program	
New York	No Program. Legislation pending to grant Board power to implement a program (AB 7604, SB 4135)	
North Carolina	State "Quality Review" Program (Sec. 93-12(8c); Reg. Subchp. 8M)	X
North Dakota	Positive Review Program (Reg. Art. 3-05)	X
Ohio	"Quality Review" Program (Sec. 4701.04; rule 4701-13-04 through -10)	
Oklahoma	No Program	

STATE	PROGRAM	REQUIRED FOR RELICENSURE
Oregon	No Program. Review of Financial Statements in lieu of disciplinary action by Board (Sec. 673.175)	
Pennsylvania	No Program	
Puerto Rico	No Program	
Rhode Island	"Quality Review" Program (Sec. 5-3-11(1)(m))	X
South Carolina	No Program. Board has power to implement program (Sec. 40-1-140)	
South Dakota	"Quality Review" Program (Sec. 36-20A-15 and -33; Reg. Chp. 20:37:13)	X
Tennessee	"Quality Review" Program (Sec. 62-1-11(a)(14) and Sec. 1; Rule 0020-1.14)	
Texas	"Quality Review" Program (Sec. 15B; Reg. Chp. 527)	X
Utah	"Quality Review" Program (Sec. 58-26-7(5), eff. 7/22/94; Rule R-156-26a)	X
Vermont	Report Review Program (Sec. 75(c) and (d))	
Virgin Islands	No Program	
Virginia	No Program	
Washington	Quality Assurance Review Program (Sec. 18.04.055(9); Reg. 4-25-280)	X
West Virginia	No Program	
Wisconsin	No Program	
Wyoming	"Quality Review" Program (Reg. Chp. IX)	X

¹ Random selection of practice unit as condition for renewal.

² Board may require through statistical sampling.

³ Selection based on survey of firms.

AICPA State Legislation Department
September 1994

Information compiled from CCH Accountancy Reporter

CHAPTER 16
INTRODUCTION TO QUALITY CONTROL FOR A TAX PRACTICE

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CHAPTER 16

INTRODUCTION TO QUALITY CONTROL FOR A TAX PRACTICE

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CHAPTER 16

INTRODUCTION TO QUALITY CONTROL FOR A TAX PRACTICE

16.000 OVERVIEW

16.001 Your firm's peer review will *not* examine the firm's tax practice. The AICPA's Peer Review Program does not specifically address tax (or management consulting) practices, except to the extent that either is associated with the issuance of financial statements. For example, accounting work related to tax provisions and tax accruals that are contained in financial statements is examined in a peer review, but the actual preparation of the same client's tax return is *not* reviewed.

16.002 Specific *enforceable* quality control standards have not been formally established for tax practices, except for perhaps the provisions of U.S. Treasury Department Circular 230 (Treasury Circular 230.)

16.003 However, the Tax Practice Guidelines Task Force, under the auspices of the Tax Practice Management Committee of the AICPA's Tax Division, published a *voluntary* tax practice review program. It can be used by firms to self-assess and evaluate their tax practices or as a framework for voluntary firm-on-firm tax practice reviews.

16.004 Additionally, the authors believe some type of quality control system is appropriate for a firm's tax practice because of the potential legal exposure, as well as because of the many benefits a quality control system can provide. Thus, this Manual provides you with certain tax practice related guidance because tax work is usually such an important aspect of an overall practice that you cannot afford to ignore it.

16.005 This chapter explains the quality control policies and procedures in the context of a tax practice:

- The purpose of a quality control system in your tax practice,
- A description of a quality control system and of how you might design and implement one for your tax practice,
- Authoritative tax quality control literature, *and*
- The collateral benefits of a quality control system for your tax practice.

Current Status of Standards

16.006 The tax practice review program is *not* mandatory, and the accounting and auditing peer review program does not cover your tax practice.

16.100 PURPOSE OF A QUALITY CONTROL SYSTEM

16.101 With respect to your tax practice, a quality control system should ensure:

1. Efficient delivery of practical professional services,
2. Compliance with the AICPA's *Statements on Responsibilities in Tax Practice* (SRTPs) and Treasury Circular 230,
3. Enhancement of public confidence in the profession, *and*
4. Risk reductions.

16.200 DESCRIPTION OF QUALITY CONTROL SYSTEMS; DESIGN AND IMPLEMENTATION

16.201 Your firm's quality control system is the overall set of policies and procedures that it must establish to ensure compliance with the quality control standards of the accounting profession and the specific requirements of the firm, its personnel, and its clients. As emphasized throughout this Manual, different firms need different quality control systems to meet their particular needs.

16.202 An effective quality control system for your firm's tax practice should address the AICPA's *Statement on Guidelines for Tax Practice Quality Control*, the guidance in the SRTPs, and the requirements of Treasury Circular 230. Just as no single accounting and auditing quality control system will work for all firms, no single tax quality control system will work either. Accordingly, you should custom-design your firm's tax quality control system to fit its specific needs.

General Considerations

16.203 Even though the AICPA has issued voluntary standards for a quality control system for a tax practice, you must use your own judgment and common sense to create a system that will work for your particular practice. The general concepts discussed in Chapter 2 will also apply to your firm's tax quality control system. Keep in mind, however, that such a tax quality control system is likely to be less comprehensive and less formal than your firm's accounting and auditing quality control system. Accordingly, some of the procedures that you decide to use in your firm's accounting and auditing practice may not be applicable to its tax practice.

16.204 Nevertheless, *always* be sure to follow certain general quality control considerations in your firm's tax practice. Some key concepts are summarized below.

Communication as Part of Quality Control

16.205 Communicate relevant policies and procedures to your personnel. Your firm could have the greatest system in the world, but it will not work if nobody knows about it.

Documentation of Quality Control

16.206 At a minimum, you ought to develop written guidelines regarding the tax return preparation policies and procedures your firm follows, including guidelines for rendering tax advice. In addition, establish your firm's own rules regarding workpaper content and documentation of inquiries made of clients.

16.207 Design your firm's quality control materials (such as the forms, checklists, manuals, and practice aids used in conducting your tax practice) and use them to document compliance with your firm's quality control system.

Monitoring of System Effectiveness

16.208 Continually evaluate and, if necessary, revise your firm's quality control system so that you always know that your firm is in compliance with professional standards.

Objective Factors Affecting Quality Control

System Design

16.209 How you design your firm's tax quality control system depends upon a number of relevant factors, such as:

- Firm size,
- Nature of practice,
- Organizational structure, *and*
- Number, location, and autonomy of offices.

16.210 These factors are similar to those that apply to the design of the quality control system for your firm's accounting and auditing practice. However, the nuances change somewhat when you apply them to your firm's tax practice.

Firm Size

16.211 The smaller a firm is, the closer the proprietor or partners are likely to be to the daily operations and decision-making process. Conversely, larger firms tend to be more decentralized. Accordingly, large firms need more explicit and formal policies and procedures.

Nature of Practice

16.212 If your practice is primarily (or entirely) tax-oriented, its needs are different from a firm that generally issues financial statements. Similarly, if your firm services clients in specialized industries, its quality control requirements must be responsive to that part of the practice.

Organizational Structure

16.213 If your firm's decision-making process rests principally with one person, or with a small group of people who work together closely, its quality control system can omit some of the forms and procedures that might otherwise be necessary. In a larger firm, whose partners cannot all be personally involved in each and every decision, a more formal system is necessary.

Number, Location, and Autonomy of Offices

16.214 If your firm has several offices, it will usually need a more comprehensive set of policies and procedures — particularly if the offices are far apart and autonomous — than a similarly sized firm operating out of one office would need.

The Subjective Factor: Professional Judgment

16.215 Because of the variety of factors that can significantly affect the nature and scope of your firm's tax quality control system, and because of the subjectivity involved in the accounting profession, no single quality control system is appropriate — or even useful — for all CPA firms. Use professional judgment and common sense in designing the right quality control system for your particular firm.

16.300 HOW THE NINE ELEMENTS OF QUALITY CONTROL IN SQCS NO. 1 RELATE TO YOUR FIRM'S TAX PRACTICE

16.301 Although Statement on Quality Control Standards No. 1 (SQCS No. 1), *System of Quality Control for a CPA Firm*, does *not* specifically cover your firm's tax practice, all of its quality control elements appear in the AICPA's *Statement on Guidelines for Tax Practice Quality Control*, except that "advocacy and integrity" replaces "independence."

Advocacy and Integrity

16.302 The first quality control element contained in SQCS No. 1 is independence, but independence is not required to prepare or sign a tax return or to render tax advice. Therefore, under the voluntary tax practice quality control program, the element of advocacy and integrity replaces independence. If your firm provides tax services in situations in which it is not independent, however, you must remember that the firm cannot expand its work to include audits or reviews, and that compilations must bear a special disclosure.

16.303 How to Address Advocacy and Integrity. Your firm's policies and procedures should ensure that its tax staff members maintain their professional integrity in performing their duties as client advocates. Your firm should:

1. Require that people at all organizational levels adhere to the AICPA Code of Professional Conduct and the rules, regulations, interpretations, and rulings of the Internal Revenue Service (IRS) and any other regulatory agencies, to the extent applicable, or be able to document and justify appropriate departures (for example, a filing position contrary to an IRS revenue ruling). In addition, tax professionals should be familiar with the AICPA's SRTPs.

2. Communicate policies and procedures relating to advocacy and integrity to people at all organizational levels within the firm. This includes (a) the need to treat as confidential any and all information regarding client tax matters, and (b) independence of mental attitude in client relationship.
3. Monitor compliance with policies and procedures relating to advocacy and integrity.

16.304 Basic Approach. The authors recommend that specific procedures should address confidentiality and adherence to legal and professional standards. All client tax matters must be confidential, and you should require staff members to maintain this confidentiality. You should also require all tax staff members and partners to adhere to the rules and regulations of the IRS, the AICPA, the revenue collecting body in your state, and any other governing agencies; your firm should require the staff and partners to justify and document any departures from these regulations.

Practice Tip:

Requiring staff members to sign a confidentiality agreement is a good way to emphasize and enforce confidentiality agreements. Also, stress confidentiality in staff handbooks and in staff training.

Consultation

16.305 Contrary to popular belief, tax engagements are more likely than audit engagements to result in litigation against CPAs. In light of the prevalence of litigation against tax preparers and advisors, you would be wise to establish internal guidelines regarding situations requiring research or outside consultations with established experts. Such guidelines can be particularly important with regard to off-the-cuff telephone advice to clients.

16.306 How to Address Consultation. According to the Tax Practice Guidelines Task Force's quality control document, you should establish policies and procedures to "provide the firm with reasonable assurance that people will seek assistance, to the extent required, from persons within and [without] the firm having appropriate levels of knowledge, competence, judgment, and authority."

16.307 Your firm should:

1. Identify areas and specialized situations in which consultation is required, and encourage people to consult authoritative sources in other situations that may be complex or unusual to them.
2. Designate individuals within and without the firm as consultants to serve as authoritative sources, and define their authority in consultative situations. Provide procedures for resolving differences of opinion between the consultants and the people working on an engagement.
3. Specify the responsibility for creating documentation of the results of the consultation and the extent of the documentation to be provided.

16.308 Basic Approach. Identify technical areas and general circumstances in which your staff members and partners should consult with the appropriate experts (including research resources). Then you should take the following steps:

1. Prepare a list of professionals both inside and outside the firm who are authorities in particular technical areas.
2. Decide how and when consultations should take place, who must approve them, and what price will be paid for an outside consultation (or at least how one will be set).
3. Decide how to resolve differences of opinion between the tax engagement staff member or partner and the authoritative expert.
4. Document the actual consultation, the opinion, and the conclusion. (See sample consultation form in section 4.604 of this Manual.)

Supervision

16.309 As a protection from legal liability, establish policies and procedures to supervise and review the work of all personnel who prepare tax returns or render advice to clients.

16.310 How to Address Supervision. Your firm's tax engagements should be appropriately planned, supervised, and reviewed. Your goal should be to ensure that all work meets your firm's standards as well as those of the accounting profession.

16.311 Your firm should:

1. Provide procedures for planning engagements, including specific evaluation of risk factors in the engagement.
2. Provide procedures for maintaining the firm's standards in the performance of the work.
3. Provide procedures for monitoring and reviewing engagement working papers, reports, tax returns, tax opinions, substantive tax correspondence, and oral advice.

16.312 Basic Approach. Take the following steps:

1. Analyze risk factors for performing each tax engagement.
2. Prepare a tax planning memorandum to document both administrative and technical decisions about the engagement.
3. Require that:
 - a. The individual preparer initial all tax workpapers and files;
 - b. The individual preparer support and document all conclusions; *and*
 - c. An appropriate level of staff review all tax work.

Professional Development

16.313 Each member of your firm's tax staff must have the knowledge and skills necessary to complete the tasks and responsibilities that he or she is assigned. Properly trained personnel are less likely to commit serious errors and are more likely to recognize situations requiring consultation. Continuing professional education (CPE) helps ensure that tax department members have developed the skills to perform their duties.

16.314 How to Address Professional Development. Establish guidelines for the amount of training that each tax staff member and partner must receive during a specified period of time and ensure that these guidelines adhere to the AICPA's requirements and those of your state board of accountancy.

16.315 Your firm should:

1. Establish guidelines and requirements for the firm's tax education program and communicate them to all people involved in tax work.
2. Ensure that information about current tax developments, changes in professional standards affecting tax practice, and materials containing the firm's policies and procedures affecting its tax practice is made available to everyone involved with tax work.
3. Encourage people to grow and mature as individuals and as professionals through seminars, workshops, college and university course work, and self-study programs. Also provide, to the extent necessary, programs not otherwise readily available so that the firm's needs for people with expertise in specialized areas and industries are filled.
4. Provide on-the-job training during the performance of tax work.

16.316 Basic Approach. The AICPA requires members in public practice to complete 120 hours of CPE credits during a rolling three-year period, with a minimum of 20 hours in any given year. Most state boards of accountancy have adopted similar requirements; in some states, the general subject areas of CPE courses must fall within certain guidelines — for example, a minimum of 10 hours of tax training, 20 hours of accounting and auditing training, and so forth. You must be aware of the specific rules in your state.

16.317 Decide how appropriate courses are to be selected (for example, as determined by the managing partner, as requested by the staff member based on certain criteria, or as set by firm policy) and how to communicate the decision. Also be sure to maintain appropriate CPE records.

Acceptance and Continuance of Clients

16.318 As a practical matter of risk reduction, you do not want to be associated with clients of questionable integrity. Moreover, the AICPA is beginning to cite examples of situations, such as knowledge of certain errors, in which your firm may want to withdraw from tax engagements.

16.319 How to Address Acceptance and Continuance. Investigate potential clients before accepting the work and reevaluate clients annually thereafter.

16.320 Your firm should:

1. Establish procedures for the evaluation and approval of prospective clients.
2. Establish procedures to document the client's understanding and acceptance of (a) the scope of the firm's services, (b) the firm's responsibility for tax advice and returns, and (c) the financial aspects of the client's relationship with the firm.
3. Establish procedures to review and evaluate tax clients at the end of specific periods or upon the occurrence of specified events to determine whether the relationship should be continued, modified, or terminated.

16.321 Basic Approach. Just as with financial statement engagements, evaluate prospective tax clients in terms of risk, integrity of management and ownership, competence of management, and reasonableness of expectations. You should also document in an engagement letter the scope of the tax services to be performed.

Hiring

16.322 You will increase the chances that a job will be completed correctly if your firm hires the right people — that is, people with appropriate skills and characteristics.

16.323 How to Address Hiring. Your firm's hiring policies and procedures should reasonably ensure that the tax staff has the appropriate qualities and skills to perform competently.

16.324 Your firm should:

1. Maintain a program for hiring qualified people by planning for future requirements, establishing hiring objectives, and setting qualifications for those involved in the hiring function.
2. Establish guidelines for evaluating potential hirees at each level.
3. Inform applicants and new hirees of the firm's policies and procedures relative to them and their work.

16.325 Basic Approach. Take the following steps:

1. Establish hiring objectives for the tax department —
 - Determine the staff size and level needs (including paraprofessionals, part-time employees, and use of accounting and auditing staff), *and*
 - Determine what characteristics and skill levels you want your tax staff to have.
2. Establish guidelines and qualifications for evaluating and selecting potential employees.

Assigning Personnel to Engagements

16.326 After your firm has hired the right people and established professional development standards to ensure that they are properly trained, your next concern should be to assign them to situations for which they are properly equipped and have sufficient experience.

16.327 How to Address Assigning Personnel to Engagements. From a quality control point of view, you should ensure that your firm's tax staff members and partners have the technical competence necessary to perform their particular assignments.

16.328 Your firm should:

1. Delineate the firm's approach to assigning people, including the planning of overall firm, office, and tax work needs and the measures employed to achieve a balance between engagement requirements, individual qualifications, individual development, and utilization.
2. Designate an appropriate person or persons to be responsible for assigning people to engagements.
3. Provide for the approval of the scheduling and staffing of individual engagements by the person with responsibility for the engagement.

16.329 Basic Approach. Take the following steps:

1. Give an appropriate person or group of persons responsibility for assigning staff members and partners to tax engagements.
2. Develop an overall objective for assigning personnel to engagements, taking into account engagement requirements, staff members' skill levels and professional development, staff use (chargeable as opposed to nonchargeable hours), and flexibility in scheduling.

Advancement

16.330 This quality control element is closely related to assigning personnel to engagements. It further emphasizes the need to adopt and implement policies and procedures that ensure that you do not assign your personnel to work that is over their heads.

16.331 How to Address Advancement. You should reasonably ensure that employees selected for advancement have the qualifications necessary to fulfill the responsibilities they will assume.

16.332 Your firm should:

1. Establish qualifications for the various levels of responsibility for people involved with tax work in the firm.
2. Periodically evaluate the performance of tax professionals and other personnel involved in the tax practice and review their progress with them. Maintain personnel files containing documentation relating to the evaluation process.
3. Assign responsibility for making promotion decisions.

16.333 Basic Approach. Take following steps:

1. Establish criteria and qualifications for the various levels of tax staff that your practice requires and communicate these requirements to your staff.
2. Periodically, but at least annually, evaluate the performance of your staff, based on the criteria and qualifications that you have set. (The evaluation should be documented; see Chapter 10 for a sample form.)
3. Maintain personnel files for each tax staff member and partner that contain performance evaluations and other documents relating to the advancement process.

Inspection

16.334 The purpose of the inspection element is to ensure that your firm is in fact following the tax quality control policies and procedures that it has established.

16.335 How to Address Inspection. If you decide you want your firm to comply with the Tax Division's voluntary practice monitoring program, establish policies and procedures that reasonably ensure that someone carefully inspects the quality control system for the firm's tax practice at least annually to determine its effectiveness and recommend any necessary corrective action.

16.336 Your firm should:

1. Define the scope and content of the firm's inspection program.
2. Provide for reporting inspection findings to the appropriate management levels and for monitoring actions taken or planned.

16.337 Basic Approach. Define the nature, extent, and timing of your firm's inspection program and require reporting to the managing partner (or an equivalent person who is *not* responsible for the quality control program). Additionally, establish monitoring procedures to ensure that the inspection's recommendations are followed — for example, having the managing partner (or quality control partner or proprietor) perform an operational review of the recommended actions a few months after the inspection.

16.338 Either your firm's professionals or an outside firm can perform the actual inspection. Your choice will be based on the size of your firm and the extent of its quality control policies and procedures.

16.400 TAX STANDARDS LITERATURE

16.401 Although present peer review standards do not specifically cover your tax practice, the following standards do cover it:

1. The AICPA's SRTPs as revised in 1988 and in 1991 and the related Interpretation,

2. The AICPA Tax Division's Tax Guidelines for Voluntary Tax Practice Review, *and*
3. Treasury Circular 230.

16.402 Additionally, in some states IRS action can be the basis for disciplinary action, including the possible revocation of a CPA certificate.

AICPA SRTPs

16.403 Between 1964 and 1977, the AICPA's Federal Taxation Executive Committee issued 10 SRTPs. It withdrew the first two in 1982, revised and renumbered the remaining eight in August 1988, and issued an Interpretation in 1990. In 1991, additional revisions were made to two of them. This Manual refers to the 1988 and 1991 revisions, which for the most part clarify, rather than change, the previous statements. Although brief summaries are provided below, you should *read and understand the actual AICPA pronouncements*.

16.404 Advisory Nature. There is a *major difference* between the SRTPs and many other AICPA pronouncements because the SRTPs are only *advisory* in nature. The SRTPs carry the following legend:

Statements on Responsibilities in Tax Practice are published for the *guidance* of members of the Institute and *do not constitute enforceable standards*.

Statements containing recommended standards of responsibilities that are more restrictive than those established by the Internal Revenue Code, the Treasury Department, or the AICPA's Code of Professional Conduct depend for their authority on the general acceptability of the opinions expressed. [*Emphasis added.*]

16.405 IRS View. Although it is not yet known whether the AICPA will ever view the SRTPs as a binding code of conduct, IRS views them as an important source of the accounting profession's accepted customs and practices, to which the IRS looks to illuminate the somewhat vague standards of Treasury Circular 230. Thus, "they can, in many circumstances, become quasi-enforceable rules by the IRS under Circular 230." (See Gardner, Willey, and Moore, "CPAs' Responsibilities in Tax Practice," *The CPA Journal*, January 1989, Vol. 168, No. 1, page 12. See also Raby, "The Role of Disclosure in Tax Return Preparation," *The Tax Adviser*, March 1989, Vol. 20, No. 3, page 157.)

16.406 SRTP (1988 Rev.) No. 1. SRTP No. 1, *Tax Return Positions* (TX section 112 of *AICPA Professional Standards*), advises that:

1. You should not:
 - a. Recommend to a client a position regarding the tax treatment of any item on a tax return unless you have a good faith belief that the position has a realistic possibility of prevailing on its merits if it is challenged (referred to as the "realistic possibility standard"),
 - b. Sign a tax return as a preparer if you know that the return takes a position that you could not recommend under the standard set forth in paragraph (a),
 - c. Recommend a tax position that exploits the IRS audit selection process, *or*

- d. Recommend a tax position that merely serves as an arguing point to obtain leverage in bargaining and negotiating with the IRS.
2. You should employ a good faith standard whereby you may recommend a tax position that you conclude is not frivolous, "so long as the position is adequately disclosed on the return or claim for refund." Your good faith conclusion should be supported by:
 - a. Well-reasoned articles,
 - b. Treatises,
 - c. IRS General Counsel Memoranda,
 - d. A General Explanation of a Revenue Act (a "blue book") prepared by the staff of the Joint Committee on Taxation, *or*
 - e. Written IRS determinations like private letter rulings.
3. Where relevant, you should "advise the client as to the potential penalty consequences of a recommended tax return position and the opportunity, if any, to avoid such penalties through disclosure."

16.407 SRTP Interpretation 1-1. In 1990, SRTP Interpretation 1-1, *Realistic Possibility Standard*, was issued. This Interpretation clarified that "to meet the realistic possibility standard, a CPA should have a good-faith belief that the position is warranted by existing law or can be supported by a good-faith argument for an extension, modification, or reversal of existing law through the administrative or judicial process....Such a belief must be based on sound interpretations of the tax law."

Practice Tip:

Understand that clients may later try to sue you if you have not adequately warned them about possible penalties — such as the substantial underpayment penalty contained in section 6661 of the Internal Revenue Code — and how to attempt to avoid them.

Although you should advise the client about disclosing tax positions, it is up to the client to decide whether and how to make a disclosure. Be extremely wary of situations in which your client chooses to ignore your advice and not make the disclosure that you recommend.

16.408 SRTP (1988 Rev.) No. 2. SRTP No. 2, *Answers to Questions on Returns* (TX section 122) advises making a reasonable effort to obtain information from a client and answering all questions on a tax return appropriately before signing the return as the preparer. SRTP (1988 Rev.) No. 2 recognizes the following reasonable grounds for omitting an answer:

- Unavailability of information,
- Genuine uncertainty about the meaning of the question, *and*

- The voluminous nature of the answer (in which case assurance should be given that the data will be available for examination).

However, you should not omit an answer merely because it might prove disadvantageous to the client.

16.409 SRTP (1988 Rev.) No. 3. SRTP No. 3, *Certain Procedural Aspects of Preparing Returns* (TX section 132) advises that in preparing or signing a tax return you may place good faith reliance, without verification, on information furnished by a client or third party. However, you are not excused from making reasonable inquiries if the information appears to be incorrect, incomplete, or inconsistent with otherwise known facts. Additionally, if the IRS requires specific documentation (for example, substantiation of travel and entertainment deductions), you should ask whether the conditions for deductibility have been met.

16.410 SRTP (1988 Rev.) No. 4. SRTP No. 4, *Use of Estimates* (TX section 142), advises that you may use a taxpayer's estimates to prepare a tax return if (1) obtaining exact data is impractical and (2) the estimated amounts are reasonable under the facts and circumstances known to you. You should not present estimated amounts in a way that misleadingly implies greater than actual accuracy. In most cases, you need not disclose that estimates were used, but there are a few exceptions to this general rule. Estimates should not become a routine substitute for good recordkeeping.

16.411 SRTP (1988 Rev.) No. 5. SRTP No. 5, *Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision* (TX section 152), advises that, unless a client is legally bound to a specific tax treatment (for example, because of a closing agreement with the IRS), you may recommend a treatment of a similar item that differs from the conclusions of an administrative proceeding or court decision that involved a client's prior return.

Practice Tip:

In such a case, you may find it advisable to recommend that a client make a disclosure in order to attempt to avoid a substantial underpayment penalty.

16.412 SRTP (1991 Rev.) No. 6. SRTP No. 6, *Knowledge of Error: Return Preparation* (TX section 162), advises to inform a client promptly if you become aware of an error in any previously filed tax return or of a failure to file a required tax return. You should also recommend measures to be taken (your recommendations may be oral, if you wish). You are *not* permitted to inform the IRS without the client's consent, unless the law requires you to do so. If the client does not correct the error, you should consider withdrawing from the current year's engagement and discontinuing your professional relationship with the client.

16.413 This statement defines an "error" as "any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in SRTP No. 1." Insignificant matters are not included.

Practice Tip:

It is a good idea always to consult with your firm's attorney about such matters.

16.414 SRTP (1991 Rev.) No. 7. SRTP No. 7, *Knowledge of Error: Administrative Proceeding* (TX section 172), advises to inform a client promptly if you became aware of an error in any tax return that is the subject of an administrative proceeding (that is, an IRS examination, appeals conference, or the like) unless a lawyer has engaged you to provide assistance in a matter relating to the lawyer's client. You should also recommend measures to be taken (your recommendations may be oral, if you wish). You are *not* permitted to inform the IRS without the client's consent, unless the law requires you to do so. If your client does not disclose the error before the conclusion of the administrative proceeding, you should consider withdrawing from representation of the client in the administrative proceeding and in other professional matters.

16.415 As in SRTP No. 6, this statement defines an "error" as "any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in SRTP No. 1." Again, insignificant matters are not included.

Practice Tip:

It is a good idea always to consult with your firm's attorney about such matters.

16.416 SRTP (1988 Rev.) No. 8. SRTP No. 8, *Form and Content of Advice to Clients* (TX section 182), advises that your tax advice should be professionally competent, appropriately serve client needs, and follow the standards set forth in SRTP (1988 Rev.) No. 1. You are advised to inform clients that your tax advice reflects professional judgment and that subsequent developments could affect previous professional advice. Use of precautionary language — for example, that your advice is based on facts as the client has stated them and on authorities that are subject to change — is recommended.

Practice Tip:

The authors recommend using engagement letters in your firm's tax practice. They can greatly reduce the possibility of misunderstandings with clients and, accordingly, reduce the likelihood of lawsuits or state board complaints.

SRTP Summary

16.417 Use the following summary to help you determine whether your firm's tax practice complies with the advisory standards of the SRTPs (Rev. 1988).

1. All of the tax positions your firm recommends should have a realistic possibility of prevailing on their merits if they are challenged [see SRTP No. 1 (1988 Rev.)].
2. All of the tax positions your firm recommends should be based on good faith conclusions supported by well-reasoned articles, treaties, IRS General Counsel Memoranda, a General Explanation of a Revenue Act (a "blue book") prepared by the staff of the Joint Committee on Taxation, and/or written IRA determinations like private letter rulings [see SRTP No. 1 (1988 Rev.)].
3. Each tax return should be free of any tax position that you could not recommend under the standards set forth in items 1 and 2 above [see SRTP No. 1 (1988 Rev.)].
4. Advise the client of potential penalty exposures from all tax positions you recommend and of any opportunities to avoid such penalties through disclosure [see SRTP No. 1 (1988 Rev.)].
5. Make a reasonable effort to obtain information from the client and to answer questions on the tax return appropriately [see SRTP No. 2 (1988 Rev.)].
6. Make reasonable inquiries about client-furnished information that appears to be incorrect, incomplete, or inconsistent with otherwise known facts [see SRTP No. 3 (1988 Rev.)].
7. Advise clients to disclose departures from a conclusion in an administrative proceeding or court decision involving a prior return of that client [see SRTP No. 5 (1988 Rev.)].
8. If you become aware of an error in a previously filed tax return, promptly inform the client and recommend measures to be taken [see SRTP No. 6 (1991 Rev.)],
9. If you become aware of an error in any tax return that is the subject of an administrative proceeding, promptly inform the client and recommend measures to be taken [see SRTP No. 7 (1991 Rev.)].
10. Caution each client that your firm's tax advice is based on facts as the client has stated them and on authorities that are subject to change [see SRTP No. 8 (1988 Rev.)].

The AICPA Tax Division's *Guidelines for Voluntary Tax Practice Review*

16.418 The AICPA Tax Division's *Guidelines for Voluntary Tax Practice Review* (product no. 024016) are intended for the guidance of AICPA members. They do *not* set enforceable standards. These guidelines are available free of charge if you are a member of the AICPA's Tax Division. Otherwise, you can order a copy for \$60 from the AICPA by calling (800) TO-AICPA.

16.419 The forms and checklists in the *Guidelines for Voluntary Tax Practice Review* are well designed, and you will find that they closely parallel their accounting and auditing counterparts in the peer review programs. You can use these materials to self-assess the quality of your tax practice, or you can engage a consultant or another firm to conduct a firm-on-firm review of your tax practice using the materials provided. Unlike a peer review, however, the results of your firm's voluntary tax practice review will

not be further reviewed by the AICPA or any other administering entity. In fact, even if you engage an outside party for a firm-on-firm tax review, nothing will leave your firm other than the engagement letter.

16.420 *Guidelines for Voluntary Tax Practice Review* includes:

- Introductory and explanatory materials;
- The AICPA's new "Statement on Guidelines for Tax Practice Quality Control;"
- The AICPA's new "Tax Practice Administrative Review Guidelines and Checklists," including instructions, checklists and questionnaires designed for both the reviewed firm and the reviewer;
- Sample quality control documents; *and*
- Other sample forms.

16.421 If your firm is like most practices, taxation is probably an important part of your business. If so, we believe you owe it to yourself to obtain and apply *Guidelines for Voluntary Tax Practice Review*.

Treasury Circular 230

16.422 Circular 230 was first issued in 1921 and has since been amended many times to reflect changes in tax legislation. It is voluminous, and its contents are generally beyond the scope of this manual. It is divided into five parts that cover a wide variety of topics, including authority to practice before the IRS, the IRS rules of practice, and disciplinary proceedings; thus, it contains certain regulations that apply to the tax practices of CPAs, attorneys, and enrolled agents. Disregard of Treasury Circular 230 could result in suspension of your right to practice before the IRS.

16.423 Although the Circular covers areas that extend far beyond the realm of the SRTPs, some of its points overlap those included in the SRTPs. As an example, section 10.21 of Treasury Circular 230 states:

Each attorney, certified public accountant, or enrolled agent who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error or omission from any return, document, affidavit, or other paper which the client is required by the revenue of the United States to execute, shall advise the client promptly of the fact of such noncompliance, error, or omission.

16.424 Also of particular relevance to your quality control system for your tax practice is a due diligence standard that Treasury Circular 230 imposes on CPAs, attorneys, and enrolled agents who prepare tax returns or assist in preparing, approving and filing of returns with the IRS. Other areas that Treasury Circular 230 addresses include:

- Regulation of return preparers,
- Duties of return preparers, *and*
- Penalties.

16.425 Unfortunately, one problem with Treasury Circular 230 is that it is vaguely worded and does not readily relate to any particular set of circumstances that your firm might actually encounter in its tax practice; therefore, the IRS looks to the practices and customs of the accounting profession.

Practice Tip:

The importance of reading the actual text of Treasury Circular 230 cannot be overemphasized. The document is available without charge from any IRS district office.

Treasury Circular 230 Summary

16.426 You can use the following summary to assist you in determining whether your firm's tax practice complies with the standards of Circular 230.

1. Exercise due diligence in preparing, approving, and filing tax returns and in determining the correctness of oral or written representations that you make to the U.S. Treasury Department or to clients (section 10.22).
2. Make a prompt disposition of all matters pending before the IRS (section 10.23).
3. You may not charge unconscionable fees for representing a client in any matter before the IRS (section 10.28).
4. You must not represent conflicting interests on tax return matters (section 10.29).
5. You must not make false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statements or claims in your advertising (section 10.30(a)).
6. You must not make direct or indirect uninvited solicitations of employment in matters related to the IRS (section 10.30(b)).
7. You must not endorse or otherwise negotiate any check issued in respect of income taxes to a taxpayer other than yourself (section 10.31).
8. You must not provide tax shelter opinions that do not comply with the requirements of Circular 230 (section 10.33).

16.500 BENEFITS OF A QUALITY CONTROL SYSTEM

16.501 The benefits that a quality control system will bring to your firm's tax practice are essentially the same that such a system brings to the firm's accounting and auditing practice. These benefits include:

- Policy documentation,
- A persuasive marketing tool,
- Reasonable assurance about your work product,
- Advance warning of potential problems,

- An effective training tool,
- Possible insurance premium savings,
- Proficiency,
- Personnel motivation and morale,
- Objectivity, *and*
- Conformity to practice monitoring requirements, if and when they are expanded to include tax practices.

16.502 Because of these benefits, your firm's practice risk should be reduced.

16.600 SAMPLE TAX QUALITY CONTROL POLICIES FOR CPA FIRMS

16.601 The following sample policies are intended as a minimal guide, which you should expand or adapt to your own firm's special needs. Several more detailed examples appear in the AICPA Tax Division's *Guidelines for Voluntary Tax Practice Review* and we highly recommend that you obtain and read that document.

16.602 *It is our firm's policy that our tax practice must comply with the AICPA's revised Statements on Responsibilities in Tax Practice and with Treasury Circular 230.*

In addition, it is our policy that:

- 1. Our personnel will advance our client's tax positions within the standards set by the law and by appropriate regulatory and professional bodies, such as the IRS, the AICPA, the state revenue collecting body, and any other governing agencies. All client tax matters must be confidential. Our partners and staff must justify and document any departures from these regulations.*
- 2. Our personnel will research tax positions or, if applicable, consult with individuals designed to serve as authoritative sources and/or refer to published authoritative sources.*
- 3. We will appropriately plan, supervise, and review our tax engagements.*
- 4. Each member of our professional staff will obtain the necessary continuing professional education hours to enable that individual to maintain and update his or her professional skills.*
- 5. We will subject each client to appropriate investigatory procedures prior to acceptance and annually thereafter.*
- 6. The individuals we hire as members of our professional staff must possess the characteristics that enable them to perform competently.*

7. *We will assign our professional personnel to engagements in a manner that provides adequate technical coverage and continued development of the professional personnel.*
8. *We will evaluate each professional staff member at least annually to determine that he or she is appropriately classified and assigned.*
9. *We will inspect our tax practice quality control system annually to monitor its effectiveness and to recommend corrective action, if needed.*

16.700 SUMMARY

16.701 Generally accepted, *enforceable* standards regarding quality controls for a tax practice do not exist. However, quality controls for your firm's tax practice make good business sense even if they are not formally required by the AICPA or the IRS.

16.702 By striving for quality in your firm's tax practice now, before it becomes a requirement, you can begin to enjoy the educational and other advantages that a quality control system provides in helping you maintain your competitive edge. Furthermore, mandatory quality control and monitoring of your tax practice may not be too far in the future.

16.703 Use your own best judgment and common sense in developing a quality control system for your firm's tax practice.

16.800 SAMPLE DOCUMENTATION

16.801 A checklist of steps to take in designing and implementing your firm's tax quality control system is provided below.

Checklist of Steps to Take in Designing and Implementing Your Firm's Tax Quality Control System

16.802 Once you have formed a basic picture of what your firm needs, you are ready to actually design and implement its tax quality control system. The checklist below summarizes what you might do.

	<u>Initials</u>	<u>Date</u>	<u>Comments</u>
Follow the steps indicated below to design and implement your firm's quality control system successfully.			
1. Gather the necessary information and expertise.			
a) Gather all existing written policies and procedures.	_____	_____	_____
b) Review relevant professional literature.	_____	_____	_____
c) Consider whether your firm needs to hire additional technical personnel.	_____	_____	_____
d) Determine whether a consulting review or hiring of an outside consultant would be beneficial.	_____	_____	_____
e) Consider enrolling in appropriate CPE courses.	_____	_____	_____
2. Evaluate your firm's system and redesign as necessary.			
a) Compare existing policies and procedures to minimum documentation requirements and the actual needs of your firm.	_____	_____	_____
b) Decide whether new and/or revised policies and procedures are called for.	_____	_____	_____
c) Create or acquire new forms and checklists.	_____	_____	_____
d) Set responsibilities.	_____	_____	_____
e) Create your quality control document.	_____	_____	_____
3. Implement and follow new policies and procedures.	_____	_____	_____
4. Inspect and analyze the results.			
a) Inspect system operation.	_____	_____	_____

	<u>Initials</u>	<u>Date</u>	<u>Comments</u>
b) Compare inspection findings to expected results.	_____	_____	_____
c) Formulate new or revised policies and procedures as necessary.	_____	_____	_____
d) Determine whether further revisions are necessary.	_____	_____	_____
e) Consider whether outside help is needed.	_____	_____	_____
f) Modify policies and procedures as necessary.	_____	_____	_____
5. Finalize your firm's tax quality control system.			
a) Implement final policies and procedures.	_____	_____	_____
b) Make an interim inspection (optional).	_____	_____	_____
c) Arrange for your voluntary tax practice review.	_____	_____	_____

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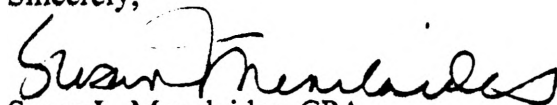
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